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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1932

No. 541

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

A. T. JERGINS TRUST

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR CERTIORARI FILED DECEMBER 8, 1932

CERTIORARI GRANTED JANUARY 16, 1933

(37238)

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Docket No. 29940

A. T. JERGINS TRUST,

Petitioner.

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPEARANCES:

For Taxpayer:

THOMAS R. DEMPSEY, Esq.,

A. CALDER MACKEY, Esq.

For Comm'r:

M. B. LEMING, Esq.

DOCKET ENTRIES.

Transferred to Mr. Goodrich 3/24/31.

1927

Jul. 25—Petition received and filed. Taxpayer notified. (Fee paid)

" 27—Copy of petition served on General Counsel.

Sep. 26—Answer filed by General Counsel.

" 28—Copy of answer served on taxpayer. Circuit Calendar.

1930

Mar. 15—Hearing set May 19, 1930, Los Angeles, California.

May 20—Hearing held before P. W. Phillips, Div. 11 on merits. Stipulations filed. Briefs due Oct. 1, 1930. Amended petition filed. General denial.

Aug. 4—Transcript of hearing of May 20 & 21, 1930, filed.

Sep. 30—Brief filed by taxpayer.

Oct. 1—Brief filed by General Counsel.

1931

Mar. 5—Findings of fact and opinion rendered, P. W. Phillips, Div. 11. Decision will be entered under Rule 50.

Apr. 17—Notice of settlement filed by General Counsel.

" 24—Motion to reconsider opinion of March 5, 1931, filed by General Counsel.

" 27—Hearing set May 20, 1931 on motion.

May 16—Motion for continuance to June 11, 1931 filed by taxpayer. May 19, 1931 granted to June 10, 1931.

" 25—Notice of settlement filed by taxpayer.

Jun. 10—Hearing had before Mr. Seawell on motion. C. A. V.

" 12—Transcript of hearing of June 10, 1931, filed.

" 12—Motion to correct transcript filed by General Counsel. Granted June 13, 1931.

Jul. 15—Decision (order of redetermination) entered, Edgar J. Goodrich, Div. 11.

Dec. 31—Motion to amend Board's findings of fact, filed by taxpayer. Granted.

" 31—Petition for review by U. S. Circuit Court of Appeals (9) with assignments filed by taxpayer.

" 31—Proof of service filed.

1932

Jan. 9—Petition for review by U. S. Circuit Court of Appeals (9) with assignments of error filed by General Counsel.

" 11—Proof of service, filed.

Feb. 4—Agreed praecipe filed. Proof of service thereon. [1*]

[Endorsed]: Filed July 25, 1927.

United States Board of Tax Appeals

A. T. JERGINS TRUST, a Trust,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 29940

PETITION.

The above named Petitioner hereby petitions for a redetermination of the deficiency set forth by the Respondent in his Notice of Deficiency, IT:CA:2554-15-60D, dated May 28, 1927, and as the basis of this proceeding alleges as follows:

*Page-number appearing at the foot of page of original certified Transcript of Record.

I.

The Petitioner is an organized trust with its principal place of business at Long Beach, California.

II.

Notice of Deficiency, copy of which is attached hereto, marked "Exhibit A" was mailed to Petitioner on May 28, 1927.

III.

The taxes in controversy are income and profits taxes for the years 1922, 1923 and 1924, amounting to the sum of $65,953.88.

IV.

The determination of the taxes set forth in the said Notice of Deficiency is based upon the following errors:

(a) The Respondent erred in determining that the income derived by Petitioner from the land owned by the City of Long Beach, California, constituted taxable income within the meaning of the provisions of the Revenue [2] Acts of 1921 and 1924 and the Sixteenth Amendment to the Constitution of the United States of America.

(b) The Respondent erred in refusing to treat as non-taxable income the proceeds derived by Petitioner from the operation of the land owned by the City of Long Beach, California.

(c) The Respondent erred in refusing to hold that the provisions of the Revenue Acts of 1921 and

1924, in so far as they or either of them imposed a tax upon the income derived by Petitioner from the land owned by the City of Long Beach, California, are in conflict with the Constitution of the United States of America and the Constitution of the State of California.

(d) The Respondent erroneously and illegally disallowed as a deduction for the year 1922 the sum of $63,977.40 which represents expenditures for labor and incidentals made by Petitioner during said year.

(e) The Respondent erred in his determination that Petitioner had two separate taxable periods in 1923.

(f) The Respondent erred in disallowing as a deduction for the period from January 1, 1923 to March 9, 1923, the sum of $213,497.67, which represents expenditures for labor and incidentals made by Petitioner during this period.

(g) The Respondent erred in disallowing as a deduction for the period from March 10, 1923 to December 31, 1923, the sum of $383,133.90, which represents expenditures for labor and incidentals made by Petitioner during this period.

(h) The Respondent erred in disallowing as a deduction for the year 1924 the sum of $452,226.75 which represents expenditures for labor and incidentals made by Petitioner during this year. [3]

(i) The Respondent erred in determining that Petitioner in 1922 made a binding election to capi-

talize expenditures made by it during the years 1922, 1923 and 1924.

V.

The facts upon which Petitioner relies as the basis of this proceeding are as follows:

1.

The A. T. Jergins Trust, (a trust), Petitioner herein, was created on April 3, 1922 for the purpose, among others, of acquiring oil properties and leases thereon and for the purpose of exploring and drilling for, producing and refining oil.

2.

(A) The City of Long Beach, California, during the years involved herein, was and now is a body politic and corporate, duly and regularly incorporated and organized under and by virtue of the laws of the State of California.

(B) Pursuant to the powers enumerated in its charter granted to it by the laws of the State of California, the City of Long Beach, during the years involved in this appeal, was and now is the owner of a tract of land situated in said city in Los Angeles County, California. This land was acquired by the City a number of years prior to 1922 and was acquired for the purpose of obtaining and storing water to be used for the protection of its properties and for the general use of its inhabitants.

(C) On or about April 11, 1922, the City of Long

Beach, by a written contract, gave to the Petitioner the right and privilege of exploring and drilling for, extracting, obtaining, removing, marketing and disposing [4] of any and all kinds of oil and gas or oil and other hydro-carbon substances which might be found in, upon or beneath the surface of the aforesaid land. A copy of said contract of lease is attached hereto, marked "Exhibit B" and by reference thereto made a part hereof.

(D) On or before April 17, 1922, Petitioner began the drilling of a well on the land above described and was successful in finding oil and subsequent events have demonstrated the fact that this land was and is valuable for the production of oil and gas. Petitioner since April 17, 1922, has drilled several wells on this ground and during the entire time Petitioner has been engaged in the production of oil and gas on this land, the City of Long Beach has maintained supervisory power and control over the various operations of Petitioner in that the City of Long Beach, California, through its duly constituted officers, has maintained during twenty-four hours of every day, an engineer-inspector who has constantly overlooked and supervised the drilling operations, the recovery of oil and gas and the marketing thereof. Petitioner and the City of Long Beach, by its duly constituted officers, jointly entered into a contract with the Standard Oil Company of California, for the sale of oil and gas produced on said premises and the City of Long Beach has since April, 1922, received its proportionate

share of the proceeds derived from the mineral products extracted from said land, all of which money so received by it having gone into its general treasury. At no time since Petitioner began its operations on this land has Petitioner taken any important step, either in the drilling of said wells or in the marketing of the mineral products derived therefrom, [5] that the City of Long Beach through its constituted officers, has not exercised control over the same. Petitioner during all of this time has been and now is an agency or an instrumentality through which the said City of Long Beach has utilized its said lands.

(E) The entire income received by Petitioner during the year 1922 was derived from the mineral products extracted and sold from this city-owned land; for the year 1923 Petitioner's entire income, with the exception of approximately $500.00, was derived from the mineral products that were extracted and sold from this city-owned land; and all of Petitioner's income, with the exception of approximately $20,000.00, received by it during the year 1924 was derived from the mineral products extracted and sold from this city-owned land. All of the income derived by Petitioner from the land owned by the City of Long Beach is, under the Constitution of the United States and the Constitution of the State of California, exempt from Federal taxation, and the provisions of the Revenue Acts of 1921 and 1924, in so far as they attempt to impose a tax thereon, are unconstitutional and void.

3.

The Respondent erroneously and illegally disallowed as a deduction for the year 1922 the sum of $63,977.40. This sum represents expenditures made during this year by Petitioner for labor, supplies and other incidentals in connection with its operations and therefore constitutes an allowable deduction within the meaning of the provisions of Section 234 (a) of the Revenue Act of the year 1921.

4.

The Respondent erroneously and illegally is attempting to impose a tax upon this Petitioner upon the basis of two separate and distinct periods in 1923. [6]

5.

The Respondent erroneously and illegally disallowed as a deduction for the period from January 1, 1923 to March 9, 1923 of the sum of $213,497.67 which represents expenditures made by Petitioner during this period for labor, supplies and other incidentals made by Petitioner in connection with its operations and therefore constitutes an allowable deduction within the meaning of the provisions of Section 234 (a) of the Revenue Act of 1921.

6.

The Respondent erroneously and illegally disallowed as a deduction for the period from March 10, 1925 to December 31, 1923, the sum of $383,133.90 which represents expenditures for labor, supplies

and other incidentals made by Petitioner during this period in connection with its operations and therefore constitutes an allowable deduction within the meaning of the provisions of Section 234 (a) of the Revenue Act of the year 1921.

7.

The Respondent erroneously and illegally disallowed as a deduction for the year 1924 the sum of $452,226.75 which represents expenditures for labor, supplies and other incidentals made by Petitioner during this year in connection with its operations and therefore constitutes an allowable deduction within the meaning of the provisions of Section 234 (a) of the Revenue Act of the year 1924.

8.

The Respondent erroneously and illegally determined that the Petitioner in 1922 had made a binding election to capitalize expenditures made by it for labor, supplies and other incidentals in connection with its operations. [7]

(a) Soon after its organization in April, 1922, Petitioner employed certain public accountants to open up for it a set of books. The Trust was originally created by three individuals and at the time of its creation, no one connected with it gave any thought or consideration to federal taxation. The accountants opened a set of books and kept, during the year 1922, a segregated account of the expenditures made for the drilling and operation of each

well. Neither the trustees nor the beneficiaries at the time these books were opened up, knew or were aware of Article 223 of Regulations 62, which in substance provides that a taxpayer may either charge to capital account or to the expense account such expenditures as are made for labor, supplies and other incidentals in connection with the drilling of an oil well.

(b) Under the rules and regulations promulgated by the Respondent and in existence during the years 1922, 1923 and 1924, the Petitioner was compelled to and did file an individual income tax return (Form 1040) for the period from April 3, 1922 to December 31, 1922, and a similar return for the period from January 1, 1923 to March 9, 1923. On or about March 10, 1923, certain amendments were made to the Declaration of Trust under which the Petitioner had theretofore been operating and from said time Petitioner has regarded itself for taxation purposes as a corporation or an association and since said time, in compliance with the rules and regulations of the Respondent, Petitioner has always filed corporate returns (Form 1120). After the amendment of its Declaration of Trust, Petitioner and its duly constituted officers became aware of the option granted by Article 223 of Regulations 62 and thereupon immediately directed that the expenditures for labor, supplies and other incidental expenses for the year 1923 and subsequent years, be charged to expenses so that they could be deducted

in determining [8] Petitioner's net taxable income. Since said time, these expenditures have been charged on Petitioner's books to the expense account and in each one of its returns filed since this time, these expenses have been deducted from Petitioner's gross income in determining its net taxable income. Up until May 28, 1924, under the rulings and regulations of the Respondent, Petitioner was treated by the Respondent as an individual for taxation purposes for the period from April 3, 1922 to December 31, 1922 and the period from January 1, 1923 to March 9, 1923. On the 28th day of May, 1924, the Respondent revised its former rulings and issued Treasury Decision 3595 which reversed his previous rulings and held Petitioner to be an association for these two periods. Petitioner was advised for the first time of the reversal of Respondent's rulings in his 20-day letter dated November 16, 1926, IT:CA:2544-15, copy of which is attached hereto, marked "Exhibit C". The Respondent in his 60-day letter, referred to herein as "Exhibit A", erroneously and illegally determined that Petitioner could not deduct the amounts expended by it during the years involved herein for the reason, as he states, that the Petitioner had made a binding election in 1922 to capitalize these expenditures and that such election was controlling in all subsequent years. At no time prior to the amendment of its Declaration of Trust did Petitioner make a binding election to capitalize these expenditures and therefore Respondent's ac-

tion in denying it the deductions claimed herein for these expenditures, is erroneous, arbitrary, unconscionable and illegal.

WHEREFORE, it is prayed that:

(1) The income received by Petitioner during the years 1922, 1923 and 1924 which was derived from the proceeds of the mineral products taken from the land owned by the City of Long Beach, be held exempt from the taxes [9] imposed by the Revenue Acts of 1921 and 1924:

(a) The provisions of the Revenue Acts of 1921 and 1924 which attempt to impose a tax on the income derived by Petitioner from the mineral products extracted by it from the land owned by the City of Long Beach, California, be held in conflict with the Constitution of the United States of America and the Constitution of the State of California.

That if the decision on the foregoing points be not decided in favor of Petitioner, that:

(3) The deductions claimed by Petitioner for the years 1922, 1923 and 1924 on account of the expenditures made by it for labor, supplies and other incidentals in connection with its operations be held to be and allowed as a deduction within the meaning of the provisions of the Revenue Acts of 1921 and 1924;

(4) The Respondent's decision, holding that Petitioner had made an election to capitalize these expenditures and that therefore it could not deduct them in determining its net taxable income for these years, be held to be erroneous and illegal;

(5) The action of the Respondent in splitting the year 1923 into two periods be held to be erroneous and illegal.

Petitioner prays for general and such other and further relief as may be meet and proper in the premises.

THOMAS R. DEMPSEY,
Thomas R. Dempsey,
HOWARD W. REYNOLDS,
Howard W. Reynolds,
A. CALDER MACKAY,
A. Calder Mackay,
Attorneys for Petitioner.

508 Security Building,
Los Angeles, California. [10]

State of California,
County of Los Angeles.—ss.

C. M. Cotton, being first duly sworn, deposes and says: That he is Vice-President of the A. T. Jergins Trust; that he has read the foregoing Petition and knows the contents thereof and that the same is true of his own knowledge except as to those matters therein stated to be upon information and belief and that as to those matters he believes it to be true.

C. M. COTTON.

Subscribed and sworn to before me this 21st day of July, 1927.

(Seal) JOHN H. KENNER,
Notary Public in and for said County and State.
My commission expires July 22, 1930. [11]

EXHIBIT B.

THE A. T. JERGINS TRUST
(A Trust)
Trustees and Officers
A. T. Jergins.....President
C. M. Cotton.....Vice-President
Ralph H. Clock.....Secretary
George L. Craig.....Treasurer
W. W. Campbell
Office in
Markwell Building
Long Beach, California
1923 [12]

DECLARATION OF TRUST
LEASE FROM THE CITY OF LONG BEACH
[13]

A. T. JERGINS TRUST
(A Trust)
AGREEMENT AND DECLARATION
OF TRUST
(As Amended)

Know All Men By These Presents:

That this 3rd day of April, 1922, we, A. T. JERGINS, R. L. HOGAN and GEO. A. LE DOUX, do hereby form a Business Trust, to be known and styled the "A. T. JERGINS TRUST (A Trust)," which is to continue in existence for a period of twenty (20) years from date hereof, pursuant to the provisions of this instrument.

ARTICLE I

Office

The principal office of this Trust shall be at Long Beach, County of Los Angeles, State of California, and at such other place in California and elsewhere as the Trustees may determine.

ARTICLE II

Purposes

The general purposes of this Trust are:

(1) To engage in and carry on the business of drilling, exploring for oil, producing, refining, distilling, treating, manufacturing, piping, carrying, handling, storing, dealing in, buying and selling oils, petroleum, natural gas, asphaltum, bitumen, bituminous rock and other mineral and hydro-carbon substances and products of all other substances, and for such purpose to buy and otherwise acquire, hold, own, manage and operate refineries, pipe lines, tanks, manufactories, machinery, tank-cars, pipe works, property and appliances that may be incident or auxiliary to said business or that may be deemed necessary or convenient by the Trustees.

(2) To purchase, own, sell, improve, lease and deal in real property of every kind and description; and to buy, sell, own, hold and deal in personal property of all kinds and descriptions.

(3) To borrow or lend money, with or without security, and to give or take mortgages, deeds of trust and other instruments for security therefor.

(4) To carry on and transact any and all kinds of business in which natural persons may lawfully engage.

(5) To promote, maintain, do, perform, execute, acquire, own, hold or dispose of each, all or anything incidental to, or necessary, convenient or proper, in the judgment of the Trustees for the time being to carry out or perform any of the matters, things or purposes aforesaid, or incidental thereto, or connected therewith, or to exercise or acquire any rights, franchise or privileges which may be deemed necessary, requisite, useful, convenient, incidental or auxiliary to any of the purposes, objects or things herein or that in the judgment of its Trustees for the time being may tend to advance the interests of the Trust, directly or indirectly.

ARTICLE III

Resulting Trust

Should the Trustees of this Trust purchase real property or any interest therein, beneficial to the Trust estate and consistent with the purposes of this Trust, with the funds of the Trust estate, in such event, pursuant to section 853 of the civil code of the State of California, the consideration for such [14] purchase shall be deemed to have been paid, in law and in equity, by and for the beneficiaries under this Trust, and the Trustees of this Trust shall hold said real property or interest therein to the use of the beneficiaries under this Trust, pursuant to the provisions of this agreement and declaration of trust;

nothing in this Article is intended, nor shall it be construed, to create an express trust in real property or any interest therein or to empower the Trustees of this Trust to purchase real property or any interest therein for the Trust estate.

ARTICLE IV

Beneficial Interests

The Beneficial Interest of the Trust shall be divided into and be represented by fifty thousand (50,000) units of beneficial interest, and the number of units of beneficial interest may be further increased by the Trustees by amendment of this instrument.

Issuance of Units for Labor or Real or Personal Property

Subscriptions to, or purchase of the units of beneficial interest of this Trust may be paid for, wholly or partly, by cash, by labor done, by personal property or by real property or leases thereof; and the units of beneficial interest so issued shall be declared and taken to be full paid and not liable for any further payments. And in the absence of actual fraud in the transaction, the judgment of the Trustees as to the value of such labor, property, real estate or leases, shall be conclusive.

ARTICLE V

Unit Certificate

The certificate of beneficial interest when fully paid for shall be issued and signed by the President, attested by the Secretary, and shall be substantially in the following form and words, to-wit:

A. T. JERGINS TRUST

(A Trust)

Of Long Beach, Cal.

The Beneficial Interest of the Trust Estate Is Divided Into 50,000 Units

Certificate of Interest

"This is to certify that.....is the owner of .....units of beneficial interest in the A. T. JERGINS TRUST, of Long Beach, California, a Trust, transferable only on the books of the Trust by the owner thereof in person or by duly authorized attorney upon the surrender of this certificate properly endorsed.

"This certificate of interest is subject to provisions and covenants contained in the Agreement and Declaration of Trust of the A. T. Jergins Trust (A Trust) of Long Beach, California, dated April 3, 1922, recorded in the office of the county recorder of Los Angeles County, State of California, in Book 938, page 266, of the records thereof, and any amendment, or amendments, thereto.

"No member is liable for any debt contracted by the Trust beyond the property of the Trust in the hands of the Trustees.

"The owner, or holder, of this certificate has no authority to contract debt, or control over the property, except as vested by the articles of this Trust.

"This certificate is the sole and only evidence of ownership.

"WITNESS the signature of the President of said Trust.

"Issued and signed this.....day of....., 19.....
Attest A. T. JERGINS TRUST (A Trust)
..... By.....
Secretary President" [15]

All of the conditions and limitations set forth in the above form shall be binding upon each member, his heirs, assigns, and legal representatives, and all creditors, and such certificate shall be transferable only on the books of the Trust in accordance with this instrument.

Beneficiaries whose certificates stand in their names on the books of the Trust shall alone be considered within the terms of this instrument and receive dividends, or have the rights of owners.

Liability of Beneficiaries

Any beneficiaries may at any time transfer or sell their unit, or units, or any of them, but each holder of a unit hereunto or certificate thereof shall be held by the fact of his acceptance of it to have assented to this Trust, and to all the provisions of this instrument.

Loss of Certificate

In case of the loss or accidental destruction or mutilation of any certificate of beneficial interest, the President may cause a new certificate to be issued upon such terms as he may see fit.

ARTICLE VI

Rights of Beneficiaries

Beneficiaries in this Trust shall have no legal right to the Trust property held from time to time by the Trustees herein provided for, and especially shall have no right to call for any partition of the Trust property or dissolution of the Trust property or dissolution of the Trust; but the units shall be personal property carrying the right of division of the profits, and at the termination of said Trust by expiration of the period fixed for its existence, or otherwise, the beneficiaries shall be entitled to a division of the principal and profit in due proportion to the number of units held by each.

ARTICLE VII

Death of Beneficiary

The death, insolvency or bankruptcy of a member of the Trust, or the transfer of his interest by sale, gift, devise, descent, operation of law, or otherwise, during the life of this Trust shall not work a dissolution thereof, or have any effect upon same, its operation or mode of business, nor shall it entitle his representatives, heirs or assigns to an accounting or to take any action in the courts in law, or equity, or otherwise, against the Trust, its members, Trustees, representatives, or its property or assets, or business operations, which shall remain intact

and undisturbed thereby; but they shall only succeed to the right of the original member to the certificate of membership and the units it represents, subject to this instrument.

ARTICLE VIII

Trustees

(a) That the management and control of the Trust estate shall be vested in five (5) trustees herein appointed.

That the Trustees are authorized to engage:

(1) In the business of searching, prospecting and exploring for mineral oil by boring or drilling therefor by any means.

(2) To buy, sell or lease in the United States, or in any other part of the world, real estate, concessions, rights and privileges in and to real estate for the purpose of prospecting for, obtaining, handling, storing, transporting, selling, and disposing of mineral oil of all kinds and varieties, including petroleum; to borrow money, and to pledge or mortgage the properties of the trust estate, real or personal, to secure the payment of the same, to buy, lease, rent or otherwise acquire and to sell such property, real, personal or mixed, as to them may seem for the best interest of the trust; to declare and to pay such dividends as to them shall seem proper and for the best interest of the Trust.

(b) That the Trustees shall hold the legal title to all property at any time belonging to this Trust,

and subject only, to the specific limitations [16] herein contained, they shall have the absolute control, management and disposition thereof, and shall likewise have the absolute control of the conduct of all business of the Trust; and the following enumeration or specific duties and powers shall not be construed in any way as a limitation upon the general powers intended to be conferred upon them.

(c) That the Trustees shall have authority to make all such contracts as they may deem expedient in the conduct of the business of the Trust; to confer, by way of substitution, such power and authority on the President, Treasurer and Secretary, and other officers and agents appointed by them, as they may deem expedient, to collect, sue for, receive and receipt for all sums of money at any time becoming due to said Trust; to engage counsel, and to begin, prosecute, defend and settle suits at law, in equity or otherwise, and to compromise or refer to arbitration any claims in favor of, or against the trust; and in general to do all things as, in their judgment will promote or advance the business which they are authorized to carry on, although such matters and things may be neither specifically authorized. In addition to the powers herein granted, the Trustees shall have all powers with reference to the conduct and management of the property of the trust which are possessed by directors of corporations under the laws of any state of the United States or any foreign country.

(d) That in so far as strangers to the trust are concerned, a resolution of the Trustees authorizing a particular act to be done shall be conclusive evidence in favor of strangers that such act is within the power of the Trustees; and no purchaser of any property belonging to the Trust estate from the Trustees shall be bound to see to the application of the purchase or other consideration paid or delivered by, or for, said purchaser to, or for, the Trustees.

(e) That the Trustees shall be known as "Trustees of the A. T. Jergins Trust," and they shall act as a board and not individually.

That stated meetings of the Trustees shall be held at least once a month and other meetings shall be held from time to time upon the call of the President, or a majority of the Trustees. A majority of the Trustees shall constitute a quorum; and the concurrence of all the Trustees shall not be necessary to the validity of any action taken by them, but the decision expressed by a vote of a majority of the Trustees present and voting at any meeting, shall be conclusive.

(f) That the Trustees may make, adopt, amend or repeal such by-laws, rules and regulations not inconsistent with the terms of this instrument as they may deem necessary or desirable for the conduct of their business and for the government of themselves, their agents, servants and representatives.

That the Trustees may also appoint from among their number or otherwise, and in the discretion, one

or more Vice-Presidents, and one or more Assistant Treasurers and Secretaries, and they shall have authority to appoint such other officers, agents and attorneys, as they may deem necessary or expedient in the conduct of their business, and shall have authority to remove from office, accept resignations, and to fill any vacancies in the offices appointed by them, for the unexpired term, and shall likewise have authority to elect temporary officers who shall serve during the absence or disability of the regular officers and may also by a majority vote of all the Trustees remove any officer or agent appointed by them.

(g) A. T. Jergins, George L. Craig, C. M. Cotton, W. W. Campbell and Ralph H. Clock constitute the Board of Trustees and officers of said Trust who shall serve until the first annual election, which shall be held on the first Saturday of April, 1923, at 10 o'clock A. M., at the office of said Trust, 637 Markwell Building, Long Beach, California, whereupon their successors shall be elected as hereinafter provided. At said election, one Trustee shall be elected for a period of five years; one Trustee shall be elected for a period of four years; one Trustee shall be elected for a period of three years; one Trustee shall be elected for a period of two years; and one Trustee shall be elected for a period of one year. [17]

Annually thereafter, on the first Saturday of April, at the hour of 10 o'clock A. M., at the office of the Trust, the regular meeting of the beneficiaries

of this Trust shall be held, and at said meeting each year, one Trustee shall be elected who shall hold office for a period of five years.

Notice of all annual regular meetings of the Beneficiaries of this Trust is dispensed with, other than the first, which is to be held on the first Saturday of April, 1923. Said Trustees shall, immediately after each annual election, elect one of their number as President, one of their number as Vice-President and shall also elect a Secretary and Treasurer, who need not be Trustees, and until the first annual meeting, A. T. Jergins shall be President, C. M. Cotton, Vice-President, George L. Craig, Treasurer, and Ralph H. Clock, Secretary. Special meetings of the beneficiaries may be called by the Trustees at any time, and in case a vacancy shall occur in the Board of Trustees, then, and in that case, within thirty days thereafter, the remaining Trustees shall call a special meeting to fill the vacancy for the unexpired term.

Notice of the first annual meeting which shall be held on the first Saturday of April, 1923, and any special meeting of the Beneficiaries of this Trust, shall be given by the Secretary, who shall cause to be sent at least ten days prior to the date of said meeting, to the owners of Certificates of Beneficial interest in this Trust, by mail, at the address of each owner of certificate or certificates of beneficial interest as shown upon the books of the Trust, a notice of said meeting, which meeting shall be held at the office of the Trust, and which notice shall

state the time of meeting and the reason for which said meeting is called, and the written certificate of Secretary that notice of the time and place of such meeting has been given by mailing to each certificate holder at his last known address as shown by the Books of the Trust, a written or printed notice of such meeting, shall be conclusive as to the notice. At any meeting of the beneficiaries of this trust, the holders of a majority of the certificates of beneficial interest shall be necessary to constitute a quorum and at such meeting a majority of the certificates of beneficial interest present and voting, shall be necessary to elect a trustee.

(h) That the President, Vice-President, Treasurer and Secretary shall have the authority and perform the duties usually incident to those officers in other organizations so far as applicable thereto, and shall have such other authority, and perform such other duties as may from time to time be determined by the Trustees. That the Trustees shall fix the compensation, if any, of all officers and agents whom they may appoint and may also pay themselves such compensation for their own services as they may deem reasonable.

That the Trustees shall cause to be kept by the Secretary elected by them a record of all meetings of the Board of Trustees, which record shall be of the same character and effect as that kept in the case of corporations, and so far as strangers to the Trust are concerned, shall be conclusive against the Trust as to the facts and doing therein stated.

That the Trustees shall not be liable for any error of judgment or for any losses arising out of any act or omission in the execution of this Trust, so long as they act in good faith, nor shall they be personally liable for the acts or omissions of each other, or for the acts or omissions of any officer or agent or servant elected or appointed by or acting for them; and they shall not be obliged to give any bond to secure the due performance of this trust by them.

That any Trustee may acquire, own and dispose of units in this Trust to the same extent as if he were not a Trustee.

ARTICLE IX.

Right to Maintain Suits.

The Trustees, in their capacity as such, may sue and be sued in any court of law or equity, or the Trust may sue and be sued in the Trust name, as provided for by the statutes of the State of California. [18]

ARTICLE X.

Vacancies.

In case of death, resignation or removal of any Trustee, the vacancy shall be filled at a special meeting of the owners of certificates of beneficial interest to be called as hereinbefore provided; said person so elected to serve during the unexpired term.

ARTICLE XI.

Acknowledgment of Certificates.

Any certificate or paper signed by the Trustees, or a copy of the record of any of the proceedings

of the Trustees, which it may be deemed advisable to record in any registry of deeds, or elsewhere, may be acknowledged by any one of the parties signing in the manner at the time prescribed by law for the acknowledgment of deeds to be recorded in such registry.

ARTICLE XII.

Employment of Agents.

The Trustees may select an Advisory Board, a President, Vice-President, a Secretary, Treasurer, a manager or managers for all or any part of the Trust's property or business, and may employ such agents, attorneys or other servants and employees, fixing their compensation and entrusting them with such authority and duties as they may deem wise.

ARTICLE XIII.

Gross and Net Income.

The Trustees shall have power to determine whether moneys or things shall, for the purpose of these presents, be considered as capital or income, and what constitutes gross income and what net income, and what constitutes gross income and what net income in any year, or part of a year, and to determine the mode in which any expense or any outgoings shall be borne as between capital and income.

ARTICLE XIV.

Dividends.

The Trustees may, from time to time, declare and pay such dividends from the earnings of the Trust

as they may deem expedient and consistent with good business judgment, keeping in mind the good of the unit holders and the interest of the Trust.

ARTICLE XV.

Accumulation of Reserve or Surplus Fund.

The Trustees shall have authority to reserve in each year such sum as they deem wise for the protection of the Trust estate and business needs thereof, from the gross or net income actually collected, as a reserve or surplus fund, with power to use said fund by the Trustees at any time for the maintenance and payment of dividends, for the payment of the charges of the Trustees or to treat the same or any part thereof as a surplus capital and to change their determination as to said fund, or any part thereof, from time to time, as to them may seem prudent and expedient, absolutely at their own discretion, but always subject to the terms of this Agreement and Declaration of Trust.

ARTICLE XVI.

Exemption from Personal Liability.

The property and funds of the Trust shall primarily and alone be charged with debts, claims, covenants, warranties, contracts or contractual obligations of the Trust, or any judgment or court decree or proceeding founded thereon, for which the Trustees and all beneficiaries shall be exempted from personal liability, and for which the beneficiaries shall not be liable for any assessment whatsoever; the Trustees or their successors, their agents, serv-

ants or representatives, shall have no power to bind the beneficiaries, or their heirs, execu- [19] tors, administrators, successors, or assigns, personally therefor; and any person, firm, corporation, co-partnership, trust, organization or aggregation whatsoever, contracting with them shall look alone to the funds and property in their hands therefor.

Insurance.

The Trustees shall, if they employ agents, or servants, in dangerous work, take out liability insurance under the laws of the State of California, insuring said agents and the Trust against loss from accident and damages; and shall pay the premiums on said insurance from the trust funds, and further comply with the laws of the State of California relating thereto.

ARTICLE XVII.

Contracting Clause.

All contracts whatsoever shall be in writing, executed in duplicate and a copy kept by the Trustees, in which shall be plainly written, printed or stamped the following clause or its equivalent, to-wit:

> "In contracting with the A. T. Jergins Trust, it is especially stipulated and agreed that no personal liability shall exist against the beneficiaries, or any of them, by reason of this contract, but the contracting parties agree to look alone to the property and assets of the A. T. Jergins Trust in the hands of the Trustees for any claim or demand arising from or growing

out of this contract and any judgment or decree that may be rendered thereon, and will neither hold nor attempt to hold any beneficiaries personally therefor."

ARTICLE XVIII.

Title and Conveyance of Property.

In all deeds and conveyances of the Trustees, or their successors, it shall be set forth in said grant or conveyance or transfer or paper or bill-of-sale, or other written evidence of holding that they hold only as Trustees for the said Trust and not for themselves, to be held in trust specifically for the A. T. Jergins Trust, to be held also strictly in compliance with this instrument.

The title to all property acquired and to be acquired from time to time by this Trust and all investments made shall be conveyed to and in the name of the Trustees as such, the successors of them under this Agreement and Declaration of Trust for and on behalf of this Trust.

ARTICLE XIX.

The Trustees may at any time, for the protection and best interests of the Trust, amend this Declaration, provided such amendment shall not change the purposes of this Trust or in any way affect, modify or change the liability of the Trustees or beneficiaries. Each amendment as aforesaid shall be in writing, signed, certified and acknowledged by the Trustees and shall be filed and recorded in such place or places as this Agreement and Declaration

of Trust shall be filed and recorded, and said Agreement as recorded shall constitute conclusive proof of the facts thereby shown. [20]

LEASE.

Know All Men by These Presents: That the following lease is this day made and entered into, in duplicate, by and between the City of Long Beach, a municipal corporation organized under the laws of the State of California and situated in the County of Los Angeles therein, lessor, and the A. T. Jergins Trust, a business trust created by and operating under an agreement and declaration of trust made and entered into by and among A. T. Jergins, R. L. Hogan and George A. LeDoux on the 3rd day of April, 1922, and filed for record in the office of the County Recorder of the County of Los Angeles, State of California, on the 6th day of June, 1923, lessee, in Book 2463 at page 29, of Official Records, Los Angeles County, California.

Witnesseth:

Lease Term and Description of Land: For and in consideration of the sum of five ($5.00) dollars to the lessor in hand paid by the lessee, the receipt whereof is hereby acknowledged by the lessor, and for and in consideration of the covenants, promises and agreements, hereinafter contained on the part of the lessee to be kept and performed, and for and in consideration of the rents and royalties to be paid by the lessee to the lessor, as hereinafter specifically provided for and agreed upon, the lessor does

hereby lease, demise and let unto the lessee, and the lessee does hereby take and accept from the lessor, for the term and time and for the purposes and under and in accordance with the stipulations, agreements and conditions hereinafter set forth, all that certain real property situated in the County of Los Angeles, State of California, and particularly described as follows:

> Farm Lot twenty-five (25), Farm Lot thirty (30), Farm Lot thirty-one (31), Farm Lot forty-one (41), Farm Lot fifty (50), Farm Lot fifty-nine (59), the east half of Farm Lot twenty-four (24) and the east half of Farm Lot thirty-two (32) of the American Colony Tract, as per map recorded in Book 19, pages 89 and 90, of the Miscellaneous Records in the office of the County Recorder of said County; excepting from Farm Lot twenty-five (25), a strip of land eighty (80) feet wide, and from the east half of Farm Lot twenty-four (24), Farm Lot thirty-one (31), the east half of Farm Lot thirty-two (32), Farm Lot forty-one (41) and Farm Lot fifty (50) a strip of land one hundred (100) feet wide, and from Farm Lot fifty-nine (59) a strip of land off the west side seventy-five (75) feet wide, at its southerly end and seventy-six and seventy-three hundredths (76.73) feet wide at its northerly end, conveyed to the Los Angeles Terminal Railway Company by deed recorded in Book 737, page 117, of Deeds, in the office of the County Recorder of said County; and excepting from Farm Lot forty-one (41), Farm Lot fifty (50) and Farm Lot fifty-nine

(59) a narrow strip of land easterly of and adjacent to the above mentioned strip of land, conveyed to the San Pedro, Los Angeles and Salt Lake Railroad Company by deed recorded in Book 1559, page 276, of Deeds, in the office of the County Recorder of said County; and subject to a right of way across Farm Lot twenty-five (25), Farm Lot thirty (30), Farm Lot thirty-one (31), Farm Lot forty-one (41) and Farm Lot Fifty (50) granted to the Union Oil Company by deed recorded in Book 1607, page 292 of Deeds, in the office of the County Recorder of said County; and subject to an easement across Farm Lot twenty-five (25) granted to the Shell Company of California by deed recorded in Book 377, page 208, of Official Records, in the office of the County Recorder of said County; and also subject to a lease of a portion of Farm Lot twenty-five (25) to R. H. Herron Company of Los Angeles; and further subject to all easements, rights of way and incumbrances of record; and finally subject to the reservation that no derrick shall be erected, no well drilled, no pipe line [21] laid, no excavation made, no improvement placed and no work done upon the west half of Farm Lot fifty-nine (59) without first having obtained the consent of the city manager of the lessor, or his successor, to the location thereof, and that no building, or other structure, shall be constructed or placed on any land within one hundred fifty (150) feet of any of the reservoirs, whether in use or not, upon said lands.

This lease is granted by the lessor and accepted by the lessee for the purpose and with the exclusive right, subject to the terms, provisions and conditions hereof to explore and drill for, develop, collect, obtain, take, save, remove, market and otherwise use, enjoy and dispose of any and all kinds of oil, gas or other hydrocarbon substances which may be found in, upon or beneath the surface of said lands; together also with the rights, subject to compliance with the terms, provisions and conditions hereof, to use and enjoy the necessary rights of way for ingress and egress in, upon and across said lands for operation thereon under this lease; together also with the rights, subject to compliance with the terms, provisions and conditions hereof, to build, erect, operate, maintain and enjoy derricks, rigs, boilers, tanks, tankhouses, pumping stations, pipe lines, telephone, power and light lines and other structures, apparatus and equipment suitable for use only in connection with the drilling for, developing, producing, collecting, saving, disposing of and transporting from said lands of said substances produced therein or therefrom, for the term of five (5) years from and after the date hereof, and so long thereafter as oil, gas or other hydrocarbon substances are produced, collected and saved from said lands in paying and commercial quantity.

Possessory Rights. The possession by the lessee of the lands herein described, with the exception of those portions of the lands herein expressly excepted or reserved by the lessor, shall be solely and ex-

clusively for the purposes hereof, excepting that the lessor, in addition to the reservations herein contained, reserves the right to occupy and use the same for agricultural, grazing and such other purposes as the lessor may deem necessary or desirable insofar as same shall not at any time of use interfere with any of the rights or necessary operations of the lessee; and the lessee shall conduct his operations upon said lands so as to interfere as little as possible with the reserved uses of said lands in the lessor.

Property Protection: The lessee shall, during the full term hereof, or during such part of said term as he shall continue to occupy the herein demised lands for the purposes hereof, protect all works, structures and improvements of the lessor, together with all water stored in reservoirs or tanks, situated and located upon said lands against any and all damage and injury of whatsoever kind or character resulting from any of the operations conducted on said lands by the lessee.

Compensation in the Event of Damage: The lessee shall pay to the lessor a fair, just and reasonable cash sum for all damages or injury caused to any of the buildings, works, structures, reservoirs, tanks, pipe lines, conduits, water or other property of the lessor situated on said lands resulting from the operations of the lessee on said lands, regardless of whether or not such damage or injury shall ensue from the negligence of the lessee or its employees or whether such damage is merely incident-

al to the operations of the lessee on said lands. If the lessor and lessee shall be unable to agree upon the amount of compensation for such damages, then each party shall, within ten (10) days after written notice by either of them to the other demanding arbitration, select and, in writing, notify the other party of an arbitrator appointed, and the two arbitrators thus appointed shall select a third person to be known as an arbitrator, and such arbitrators shall make an examination of the property concerning which the amount of compensation because of damages is in dispute or controversy, and shall consider all matters submitted by the parties relative thereto, and said arbitrators shall thereupon make a written award of the amount of any such compensation for such damage, which award of a majority of said arbitrators shall be final and binding upon the parties and the sum so determined by a majority of said arbitrators as set [22] forth in said award shall be paid in lawful money of the United States by the lessee to the lessor within thirty (30) days following receipt by the lessee of the written findings or award of a majority of said arbitrators. The expenses of arbitration shall be borne equally by the lessor and lessee, unless the amount of the award shall be equal to or greater than the amount demanded by the lessor from the lessee, in which event such expenses of arbitration shall be solely paid and discharged by the lessee.

Damage to Property of Third Persons: The lessor shall not be liable for any damage or detriment that may ensue to third persons or to adjoining property by reason of the operations carried on hereunder by said lessee, and said lessee shall be and he is hereby made personally responsible, so far as the lessor is concerned, for any and all damage and the lessee shall pay the same through voluntary settlement, compromise settlement or legal adjudication, if necessary, and will at all times save the lessor absolutely harmless therefrom.

Drilling Obligations: The lessee shall, within five (5) days following the date hereof, actively commence the work of erecting a derrick on some portion of said lands not reserved to use of lessor as hereinabove provided for, and shall actively and continuously, in a good and workmanlike manner, complete such derrick and install therein and on said lands the necessary drilling equipment, power plant and apparatus for the drilling of an oil well and thereupon shall at once commence the actual drilling of a well for the discovery and production of oil and other hydrocarbon substances; and after commencing the drilling of such well, the lessee shall drill continuously without interruption, except such interruptions as may be caused by strike, lockout, act of God, unavoidable accident, or other cause beyond the control of the lessee, until such well shall have been drilled to a depth of thirty-seven hundred (3700) feet or until oil, gas or other hydrocarbon substances shall be produced there-

from in paying and commercial quantity; and the lessee shall upon said condition continue to drill at least one well on said lands each year until there shall have been so drilled upon said lands at least one well for each ten (10) acres in area thereof; provided that if oil shall have been produced in paying and commercial quantity from any offset well drilled, as herein provided, during any of the said one-year periods, then and in that event the lessee shall be excused from drilling the additional well herein otherwise required to be drilled upon said lands during such one-year period.

Offset Drilling Obligations: When and as often as any well shall be drilled within a distance of six hundred (600) feet of any portion of said lands and shall produce oil at the rate of one hundred fifty (150) barrels, or more, per days of twenty-four hours, following an elapsed period of fifteen (15) days from and after the time such well shall have been brought to the point of production, the lessee shall, within forty-five (45) days thereafter commence the actual drilling of an offset well at the most advantageous place on said lands to offset the well so drilled within six hundred (600) feet of said lands, and shall drill such offset well continuously without interruption, except such interruptions as may be caused by strike, lockout, act of God, unavoidable accident, or other cause beyond the control of the lessee, until such well shall have been drilled to a depth of thirty-seven hundred (3700) feet or until oil, gas or other hydrocarbon sub-

stances shall be produced therefrom in paying and commercial quantity.

Abandonment of Well Because of Mechanical Difficulties: If during the drilling of any well on said lands and before the same shall have been completed or drilled to the required depth as herein provided, mechanical difficulties shall be encountered which make it impracticable to continue with the drilling of such well, then the lessee may, at its option, abandon such well and shall thereafter promptly begin the drilling of another well in lieu of the well so abandoned for such cause.

Paying Oil Well Defined: For the purpose of more clearly defining the drilling obligations of the lessee, a well shall be deemed to be a producer of oil in paying and commercial quantity when it shall produce oil of a merchantable quality at the rate of one hundred and fifty (150) barrels per day of twenty-four hours, either by flow or by continuous pumping, immediately [23] following an elapsed period of thirty (30) days from and after the date on which such well shall have been brought into actual production.

Paying Gas Well Defined: A well shall be deemed to be a producer of gas in paying and commercial quantity when there shall be produced from such well at least five million (5,000,000) cubic feet of gas per day covering a period of thirty (30) days following an elapsed period of sixty (60) days from and after the date of the completion of such well.

Production Following Discovery: If oil, gas or other hydrocarbon substances are discovered in and upon said lands by reason of the operations thereupon of said lessee, it shall with due diligence bring said well, or wells, into actual production and shall, by proper and efficient means and by the adoption of modern and approved methods at all times keep such well, or wells, at its or their maximum production, except as hereinafter provided.

The lessee shall, with all proper skill and diligence and in accordance with the customs existing among skilled operators, pump and operate each well to full capacity; provided, however, that the lessee shall be excused from so doing so long as there shall be no market for the oil produced, or in the event of congested pipe line or inability to dispose of or sell the oil.

Gas—Its Sale and Disposition: If gas is produced from said lands in paying and commercial quantity and the same can be sold and marketed to advantage, the lessee shall sell and market the same, in which event the lessee shall, at its own cost and expense, provide the necessary traps and other means of segregating and separating the oil from the gas and for the collection of the gas; and it shall supply the lessor, monthly, with the registered meter readings showing the production of gas and will, monthly, supply the lessor with a complete record and account of the volume of gas sold, together with a statement from the purchaser, or

purchasers, of such gas showing the amount of gas received by said purchaser, or purchasers, and the price paid therefor.

Well Production Tests: Whenever the lessee shall put any well or wells drilled by it on said lands on production test, it will notify the city manager, or other duly appointed and constituted agent of the lessor, of the day and hour when such production test shall begin and when the same shall end, and within twenty-four (24) hours following such production test, the lessee shall supply the lessor with a written record of such oil made of each and every well drilled on said lands four (4) times annually, and the lessor in order to procure such production test shall serve upon the lessee a written notice of such requirement at least fifteen (15) days prior to the time when such test shall be made, whereupon the lessee shall notify the lessor, through its city manager or other duly appointed and constituted agent of the lessor, of the date when such test will be made in obedience to the requirement of the lessor, and the lessee will, within twenty-four (24) hours following each test, supply the lessor with a written record thereof.

Refineries and Topping Plants: The lessee shall not erect or construct upon said lands, or any part thereof, any refinery or topping plant; provided, however, that the lessee is permitted to install a casing head gas plant thereon, at its option or election, for the purpose of converting into gasoline the gas produced on the lands.

The lessee shall not erect or construct any tanks upon said lands for the storage of oil not produced therefrom.

Taxes: The lessee shall pay all taxes and assessments which are levied or assessed upon any property which it may place on the said above described lands during the term hereof, and/or upon the oil or other hydrocarbon products stored on said lands by the lessee and not belonging to the lessor, and upon the mineral rights and interest of the lessee in said lands. All charges, taxes and assessments imposed by the State of California, United States of America or any political subdivision of either thereof, upon said lands, or upon any part or parcel thereof, except upon the improvements placed thereon by the lessee, shall be paid in the following proportions: Forty (40%) per cent thereof by the lessor, and sixty (60%) per cent thereof by the lessee; provided, however, that the lessee shall at its sole and exclusive [24] expense, pay and discharge all fees which are now or may hereafter be required to be paid by the State of California through the State Mining Bureau and the office of the State Oil and Gas Supervisor, or through such other department of the State of California which may be created for that purpose by legislative enactment.

Water: The lessee shall be entitled, at its own expense, to drill for water upon said lands and to use the same in connection with any of its operations on said lands hereunder; provided, however, that, sub-

ject to the drilling and operating requirements of the lessee from time to time, the lessor shall have the free use of all surplus water produced or developed upon said lands by the lessee.

Use of Oil and Gas for Fuel: The lessee shall not be required to yield royalty on any oil, gas or other hydrocarbon substances produced by it upon the herein described lands and used by it for fuel purposes only necessarily incidental to its operations upon lands herein demised; provided, however, that if gas is produced in sufficient quantity to provide fuel, that the lessee shall use gas for fuel and not oil.

Rents and Royalties: The lessee shall pay to the lessor, as rent and royalty for the use of said lands for the purposes aforesaid, forty (40) per cent of all oil, gas and other hydrocarbon substances produced and saved from said lands, including casing head gas, except oil, or gas, or both used for fuel purposes, as herein provided; the payments royalty to be made in money or in kind, at the lessor's option. If the rental is paid in kind it shall be stored, free of charge to the lessor, in tanks to be provided by the lessee, for a period of thirty (30) days following the calendar month in which said oil is produced.

If the royalty is paid in money, the lessee shall pay to the lessor, on or before the 20th day of each and every calendar month during said term, the said lessors rent or royalty of forty (40%) per cent at the contract price for such oil and gas paid by the

purchaser thereof, and if no contract exists concerning and affecting the sale and purchase of such oil and gas, or either oil or gas, then the highest price fixed and paid by the Standard Oil Company or Union Oil Company for oil of similar gravity produced in what is commonly known as the Signal Hill district at the time of delivery; and as to gas, at the market price for gas of similar quality produced in the Signal Hill district at the time of delivery.

The option of the lessor to take the royalty in money or in kind may be exercised once only every six (6) months and then on thirty (30) days' notice in writing to the lessee; provided, however, that if the lessor shall elect to take its royalty in money, the lessor shall have and is hereby granted the right and privilege of joining with the lessee in any contract for the sale of oil and gas, or both, and shall enjoy the same price on the sale of its oil and gas under such contract; and in the event that the lessor shall exercise such right and privilege to join with the lessee in such contract, that it shall not have the privilege of electing to take its royalty in kind until the volume of oil agreed to be sold under such contract shall have been actually sold and delivered to the purchaser. If no notice is given to the lessee by the lessor of its election to take or receive such royalty in money or in kind, it shall be conclusive that the royalties are payable in money until such time as the lessor shall, in writing, notify the lessee of its election to the contrary.

Contracts for Sale of Oil: The lessee shall, at least ten (10) days prior to the time when it shall sign any contract for the sale of oil or gas, or both, give written notice to the lessor of its intention to sign such contract and shall accompany such notice with a copy of the proposed contract, thus giving opportunity to the lessor to join in such contract for the sale of its royalty oil, if it shall elect so to do; and in the event that the lessor shall join in said contract, then the lessee shall be released from any and all obligations to pay the royalty of forty (40%) per cent in money, and the said contract shall provide that the purchaser under ths terms of said contract shall pay the royalty of forty (40%) per cent direct to the lessor. [25]

Log and Measurements: The lessee shall keep a correct and accurate log and record of each well drilled on said lands and shall, weekly, supply the lessor with a full, true and correct copy of the log of each well then in course of drilling. The lessee shall also maintain continuously on said lands following the discovery and production of oil and gas, such tanks, gauges and devices as shall be necessary for properly and accurately measuring all oil produced hereunder and all gas saved and transported.

The lessee shall construct his oil storage tanks of material of the kind and quality used and employed by skilled and experienced oil producers and shall give to the lessor, in writing, the correct measurements of each storage tank constructed by it.

The lessee shall exhibit to the lessor at any and all times upon demand of the lessor the original run tickets delivered to the lessee by the purchaser of oil, together with any records showing the delivery and sale of oil to any person other than the contract purchaser thereof, and in addition thereto the lessee, on or before the 20th day of each month, shall supply the lessor with a full, true and correct statement of all oil produced and saved from said lands during the previous calendar month, together with a duplicate copy of the statement supplied by the purchaser of oil and gas sold during the previous month, showing all deductions made from oil for temperature, water or base sediment, and the actual cost of treating said oil, in case the same shall require treatment, together with the total price received for such royalty oil.

The lessor shall have the right at all times, in the presence of the lessee, or of the duly authorized representative of the lessee, and in a reasonable manner, to test the accuracy of all gauges and measuring devices and to take copies of all accounts and records of production.

The lessee shall also furnish to the lessor, on or before the 20th day of each calendar month, a statement in writing, of the volume of casing head gas produced from the premises, if any, together with the price received for such product sold during the next preceding calendar month.

The lessor, through any of its agents or servants, is further granted the right to at all times inspect

the works and operations of the lessee on said lands.

Under What Circumstances Lessee Is Excused From Drilling: If the market price for oil produced and saved from said lands, or any portion thereof, shall at any time during the term hereof, fall below the price of seventy-five (75c) cents per barrel at tanks on the lands in which such oil shall be stored, the lessee may cease drilling operations upon such lands during and for the time that the price of oil shall so remain below seventy-five (75c) cents per barrel on the lands where produced.

Labor and Material Bills: The lessee will promptly pay when due all labor and material bills incurred incident to the drilling of wells and the carrying on of operations hereunder, or otherwise incident to the discovery, development and production of oil, gas and other hydrocarbon substances produced on said lands and the storing of the same.

The lessee shall not suffer or permit any materialmen's or labor liens to exist upon or against the lands herein demised, or any part thereof, by reason of its operations hereunder, and the lessee shall hold the lessor harmless against any and all such liens. If, however, any lien shall be filed upon said lands, or any portion thereof, by any laborer or materialman because of any dispute or controversy concerning the amount involved, between such laborer or materialman and the lessee, or for any other purpose, the said lessee shall, with due dili-

gence, defend any action brought to foreclose such lien, at its own cost and expense, and in the event of judgment being rendered against it because of the same, the lessee will promptly pay the same on final judgment, together with all costs of suit and if it shall be necessary for the lessor to defend or prosecute any action arising out of any such lien for its protection, the lessee shall pay and discharge all expense incurred, including attorneys' fees, incident thereto. [26]

The lessor reserves the right to post notices of non-liability upon said lands, as provided for in section 1192 of the Code of Civil Procedure of the State of California, and in the event that said notices shall be posted by the lessor, the lessee agrees to exercise due care and diligence in protecting such notices from defacement or destruction.

Litigation: Each of the parties hereto shall give the other written notice of any litigation affecting the lands herein described as soon as such party shall have knowledge thereof.

Drilling Methods: The wells drilled on said lands shall be drilled by means of a rotary rig of standard size and weight at least to the depth where the final water string is set, and thereafter it shall be optional with the lessee whether it shall continue the completion of such wells with rotary rig equipment or by means of standard or cable tools.

The lessee shall at all times properly protect all oil and gas-bearing strata from water infiltration and shall faithfully comply with all rules and reg-

ulations promulgated by the California State Oil and Gas Supervisor relative to water shut-offs and production from oil and gas-bearing strata.

Record of Production of Individual Wells: The lessee shall keep and shall, monthly, supply the lessor with a full, true and correct record production of oil, gas and other hydrocarbon substances produced by each individual well.

Storage: In the event that the lessor shall elect to take and receive its rents and royalties in kind, the same shall be delivered to it on the demised lands or stored for it with the products of the lessee in the lessee's tanks and/or receptacles for a period of thirty (30) days following the month in which the same shall have been produced, free of charge, after the expiration of which time said lessee may charge said lessor the usual storage rates thereof; provided, however, anything herein to the contrary notwithstanding, said lessor may construct, maintain and use tanks, pumps, receptacles and pipe lines on said lands for receiving, storing, holding, transporting and transmitting its rents and royalties in kind; provided, however, that such tanks, receptacles, pumps and pipe lines which may be so constructed by the lessor shall be so placed and constructed as to interfere as little as possible with the operations of the lessee.

If the oil produced on said lands cannot be sold, disposed of or removed therefrom by reason of there being no market for the same, or by reason of inadequate or insufficient pipe line facilities, or

for other cause beyond the control of the lessee, then the lessee shall provide and furnish storage, free of charge to the lessor, for all of the royalty oil of the lessor.

Nothing herein contained shall be so construed as to require the lessee to guarantee its tanks, containers or receptacles or the safety of the oil therein.

All oil at any time produced from said lands and secured, saved and impounded by the lessee in containers supplied by it shall be subject to such shrinkage or loss to oil produced from said lands from whatever cause, except through the negligence of lessee, shall be borne by the entire volume of oil at the time in the tanks and containers of the lessee in proportion to the ownership thereof.

Forfeiture: If the lessee shall be in default in the payment of the royalty or in the performance of any covenant or agreement herein contained by it to be kept or performed and shall continue in such default for a period of thirty (30) days following written notice of the respect in which such default exists or is claimed, then the lessee shall forfeit all rights granted it hereunder.

On the expiration of this lease or the forfeiture of the rights of the lessee hereunder, or the termination of the lease for other cause, or on the abandonment of the lands by the lessee, it shall make, execute and deliver to the lessor a quitclaim deed wherein and whereby there shall be quitclaimed to the lessor all of the right, title and interest of the lessee in and to the lands herein described. [27]

Restoration of Surface: Upon the final determination of this lease or on the forfeiture or abandonment thereof, the lessee shall remove all debris from the lands and restore the surface of the ground to as nearly its present condition as shall be physically possible.

Notices and Their Mailing: All written communications and notices from the lessor to the lessee shall be delivered personally to the lessee or may be mailed to it by registered mail and addressed to it at its office upon said lands.

All written communications and notices from the lessee to the lessor shall be delivered personally to the City Clerk of the City of Long Beach, or mailed to him by registered mail addressed to him at the City Hall, in the City of Long Beach, California.

Bond: The lessee shall, as a condition precedent to the exercise of the rights herein granted it, make, execute and deliver to the lessor, within ten (10) days from date hereof, a good and sufficient bond in the penal sum of fifty thousand ($50,000.00) dollars, in form and surety to be satisfactory to the said lessor and its officers and agents authorized to approve the same, conditioned for the faithful performance by said lessee of the terms, covenants and conditions of this lease on its part to be kept and performed.

Drilling Bond: The lessee shall, as a condition precedent to the exercise of the rights herein granted it, make, execute and deliver to the lessor, within ten (10) days from and after the date of

this lease, a good and sufficient bond in the penal sum of sixty thousand ($60,000.00) dollars, in form and surety to be satisfactory to the said lessor and its officers and agents authorized to approve the same, conditioned for the faithful performance by said lessee of the terms, covenants and conditions of this lease on its part to be kept and performed solely respecting the drilling of the first well pursuant to the provisions of that portion of the paragraph of this lease entitled "Drilling Obligations" commencing with the first of said paragraph and ending with the words "until such well shall have been drilled to a depth of thirty-seven hundred (3700) feet or until oil, gas or other hydrocarbon substances shall be produced therefrom in paying and commercial quantity."

Assignment: This lease shall not be assigned either in whole or in part, nor shall said lessee sublet said described lands in whole or in part, or sublet or assign any rights granted it hereunder, without the consent of the lessor expressed by resolution duly adopted by its City Council.

Right of Lessor to Purchase Equipment: Upon the termination of this lease by its expiration the lessor shall have the right and option to purchase, at the reasonable market value thereof, any or all of the improvements, apparatus, equipment and casing then on said lands as shall be reasonably necessary to enable the lessor to carry on the business of operating wells and caring for and storing the product thereof.

In the event the lessor and lessee shall be unable to agree upon such reasonable value, then the value of the same shall be determined by arbitration; in which latter event the lessor shall select one arbitrator and the lessee one arbitrator, the two arbitrators thus selected to select a third arbitrator, and the valuation placed thereon by a majority of said arbitrators shall be final and binding upon the parties hereto and the price to be fixed by a majority of said arbitrators shall be the price to be paid therefor by the lessor.

Should the lessor not notify the lessee of its intention to exercise said right and option to purchase at least thirty (30) days before the expiration of this lease, then the lessee shall, during the last thirty (30) days of the term of this lease remove all of said improvements, apparatus, equipment, casing and other things placed thereon by the lessee and restore the surface of all of the lands herein described to as nearly the same condition as the same are now in as shall be then possible.

However, should this lease be terminated by forfeiture or abandonment the lessee shall not remove any of the improvements, apparatus, equipment, casing or other things placed on said lands by said lessee, but the same, and all thereof, shall thereupon become and remain the property of the [28] lessor; and as sole consideration therefor, the lessee shall be released from its obligation to restore the surface of said lands to its original condition as herein provided.

Valuation Allowances: In the application of the United States Internal Revenue Laws, now existing or as may be hereafter amended or enacted, both lessor and lessee shall share in the ratio of forty (40%) per cent to the lessor and sixty (60%) per cent to the lessee in all deductions and depreciations on or for valuations allowed by the United States Government, but this shall not be construed to mean that the lessor shall yield royalty to the lessee because or on account of any internal revenue which may be assessed, fixed or levied by the United States Government.

Title: The lessor warrants that it is the owner in fee of the lands herein described.

Protection of Oil: The lessee shall not store oil in open sumps; provided, however, that if at any time oil shall be produced in such volume that the storage facilities of the lessee shall be inadequate to store the same, such oil may be stored in open sumps until the lessee can with reasonable dispatch provide additional tankage and storage facilities.

Bond Renewals: In the event that notice of the cancellation of the drilling bond for sixty thousand ($60,000.00) dollars, herein provided for, shall be given to the lessor by the surety, or any of the sureties, upon such bond, the lessee shall upon notice from the lessor of such intention to cancel and before the time fixed in such notice for such cancellation execute a good and sufficient new drilling bond to the lessor in the same penal sum for the same purpose as the original drilling bonds, in form and

surety satisfactory to the lessor and its officers and agents authorized to approve the same; and in the event of the failure of the lessee so to do within the time specified, then this lease shall be forfeited and all of the rights and privileges of the lessee hereunder shall thereupon terminate and the lessee shall thereupon surrender the possession of the real property described in this lease and all improvements placed thereon by the lessee to the lessor.

In the event that the lessor shall at any time deem the surety, or sureties, upon the bond of lessee for fifty thousand ($50,000.00) dollars for the faithful performance by the lessee of the terms, covenants and conditions of this lease on its part to be kept and performed, insufficient for the protection of the lessor, the lessee shall, within ten (10) days after written notice so to do, furnish other and additional sureties satisfactory to the lessor or a good and sufficient new bond for the same penal sum and for the same purpose in form and surety satisfactory to the lessee and its officers and agents authorized to approve the same; and in the event of the failure of the lessee so to do within the time specified, then this lease shall be forfeited and all of the rights and privileges of the lessee hereunder shall thereupon terminate and the lessee shall thereupon surrender the possession of the real property in this lease and all improvements placed thereon by the lessee to the lessor.

It is further agreed that as often as the bonds herein provided to be executed, or either of them,

or any bond given in the place of either of them, shall be cancelled or become insufficient, as herein specified, the lessee shall, in the same manner and at the same times and under the same penalties renew or otherwise make said bonds good and sufficient and satisfactory to the lessor.

Trust Contracting Clause: In compliance with the provisions of the agreement and declaration of trust, hereinabove referred to, there is inserted in this lease the following: "In contracting with the A. T. Jergins Trust, it is especially stipulated and agreed that no personal liability shall exist against the beneficiaries, or any of them, by reason of this contract, but the contracting parties agree to look alone to the property and assets of the A. T. Jergins Trust in the hands of the Trustee for any claim or demand arising from or growing out of this contract and any judgment or decree that may be rendered thereon, and will neither hold nor attempt to hold any beneficiaries personally therefor." [29]

In Witness Whereof, the lessor has caused these presents to be duly executed by its proper officers thereunto first duly authorized by Resolution No. C 263 of its City Council adopted on the 11th day of April, and said lessee has caused these presents to be duly executed by its proper officer thereunto first legally authorized on this 11th day of April, 1922.

CITY OF LONG BEACH,
By FILLMORE CONDIT,
Mayor Pro Tempore.

By CHARLES E. HEWES,
City Manager.
Lessor.

(Seal)
Attest:
H. C. WAUGHOP, City Clerk.

A. T. JERGINS TRUST,
By A. T. JERGINS,
Trustee.
Lessee.

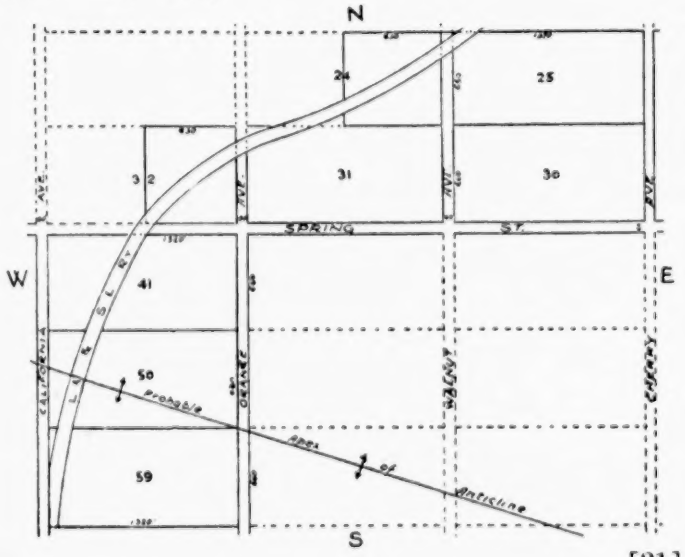
Approved as to description this 11th day of April, 1922.

CLARK H. SHAW,
Superintendent of the Water Department.

The foregoing lease is hereby approved as to form this 11th day of April, 1922.

GEORGE L. HOODENPYL,
City Attorney.

GLH—AG [30]



[31]

EXHIBIT "A"

Form NP-2

TREASURY DEPARTMENT
Washington
Office of
Commissioner of Internal Revenue
IT:CA:2554-15-60D

May 28, 1927.

A. T. Jergins Trust,
Long Beach, California.

Sirs:

The determination of your income tax liability for the taxable years 1922, 1923, and 1924, as set forth in office letter dated November 16, 1926, pursuant to the reports of the Internal Revenue Agent in Charge at San Francisco, California, and conference held in this office January 3 and 4, 1927, disclosed a deficiency in tax aggregating $65,953.88 as shown in the attached statement.

In accordance with the provisions of Section 274 of the Revenue Act of 1926, you are allowed 60 days from the date of mailing of this letter within which to file a petition for the redetermination of this deficiency. Any such petition must be addressed to the United States Board of Tax Appeals, Earle Building, Washington, D. C., and must be mailed in time to reach the Board within the 60-day period, not counting Sunday as the sixtieth day.

Where a taxpayer has been given an opportunity to file a petition with the United States Board of Tax Appeals and has not done so within the 60

days prescribed and an assessment has been made, or where a taxpayer has filed a petition and an assessment in accordance with the final decision on such petition has been made, the unpaid amount of the assessment must be paid upon notice and demand from the Collector of Internal Revenue. No claim for abatement can be entertained.

If you acquiesce in this determination and do not desire to file a petition with the United States Board of Tax Appeals, you are requested to execute a waiver of your right to file a petition with the United States Board of Tax Appeals on the inclosed Form A, and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:CA:2554-15-60D. In the event that you acquiesce in a part of the determination, the waiver should be executed with respect to the items to which you agree.

Respectfully,
D. H. BLAIR,
Commissioner.
By C. R. NASH,
Assistant to the Commissioner.

Inclosures:
Statement
Form A
Form 882. [32]

Exhibit A—page 2

STATEMENT

IT:CA:2554-15-60D

In re: A.T. Jergins Trust,
Long Beach, California.

Year	Deficiency in Tax
1922	$ 1,126.62
1923	3,368.92
1924	61,458.34
Total	$65,953.88

1922

Net income return	$11,012.98
Exemption	2,000.00
Balance taxable at 12½%	$ 9,012.98
Tax at 12½%	1,126.62
Tax previously assessed	None
Deficiency	$ 1,126.62

The above deficiency in tax is due to the fact that your association has been determined taxable as a corporation in accordance with Treasury Decision 3595, Cumulative Bulletin III-1, page 489 and Treasury Decision 3790, Cumulative Bulletin V-1, page 147.

DEPRECIATION

Assets	Cost	Rate	Amount
Tanks	$11,252.04	10%	$ 562.60
Power plant	8,448.57	10%	422.42
Building	3,166.91	5%	79.17
Building equipment	462.71	25%	57.84
Oil lines	9,916.80	10%	495.84
Water lines	719.27	10%	35.96
Gas lines	1,146.86	10%	57.34
Tools	748.67	33⅓%	124.78
Auto	1,690.00	25%	211.25
Steam lines	38.93	10%	1.95
Office furniture	107.50	10%	5.38
Wells (physical equipment)	59,376.96	11%	6,531.45
Total for 6 months—1922			$8,585.98

[33]

Exhibit A—page 3

1923

Net loss return	$323,695.55
Depreciation oil wells disallowed	33,509.76
Drilling costs capitalized	383,133.90
Income net from January 1 to March 9, 1923 originally omitted	22,287.88
Balance	$115,235.99
Depletion additional	88,284.60
Net income corrected	$ 26,951.39
Tax at 12½%	$ 3,368.92
Tax previously assessed	None
Deficiency	$ 3,368.92

Depreciation has been allowed in accordance with attached statements.

Drilling costs have been capitalized in accordance with Article 223, Regulations 62.

Depletion has been allowed in accordance with attached statements.

COMPUTATION OF INCOME FROM BUSINESS
JANUARY 1 TO MARCH 9, 1923.

Account	Income per books	Additions	Deductions	Income as Corrected
Sales	137,663.35			137,663.35
Total	137,663.35			137,663.35
Gross profit	137,663.35			137,663.35
Production expense	5,985.77			5,985.77
Well expense	4,072.92			4,072.92
Administrative expense	7,321.65			7,321.65
Depreciation on Equipment	10,290.44	5,928.42 (a)		4,362.02
—Depletion	87,751.50	(b)	5,881.61	93,633.11
Total deductions	115,422.28			115,375.47
Net income	22,241.07	46.81		22,287.88

[34]

Exhibit A—page 4

EXPLANATION OF ITEMS

(a) Depreciation: January 1, to March 9, 1923.

Asset	Cost	Acquired	Rate	Amount
Tanks	$17,427.73	1922	10	$1,742.77
Power Plant	14,323.79	"	10	1,432.38
Buildings	4,879.92	"	5	244.00
Buildings and equipment	525.96	"	25	131.49
Oil Lines	13,098.97	"	10	1,309.90
Water Lines	2,117.94	"	10	211.79
Gas Lines	2,331.11	"	10	233.11
Tools	1,242.54	"	33⅓	414.18
Auto	1,690.00	"	25	422.50
Steam Lines	372.64	"	10	37.26
Tools oil well	135.37	"	50	67.68
Office furniture	107.50	"	10	10.75
Total				$6,257.81
For 2⅓ mo. 12/31/22 to 3/9/23				$1,216.79
Oil wells, (physical equipment only):				
Cost 1922			$59,376.86	
Additions 1/1-3/9/23			21,160.18	
Total to 3/9/23			$80,537.04	
Less depreciation allowed, 1922			6,531.45	
Balance			$74,005.59	
			4¼%	3,145.23
Reserves 1/1-3/9/23	3,479,861 bbls.			
Production " "	146,688 "			
Rate	4¼%			
Total depreciation allowable				4,362.02
Depreciation per books				10,290.44
Difference				$5,928.42

The difference is due to the transfer of intangible drilling costs to capital sum returnable through depletion.

[35]

Exhibit A—page 5

1924	
Net income return	$260,372.72
Development Costs	452,226.75
Depreciation, oil wells	71,516.60
	$784,116.07
Depletion, additional	32,076.67
Net income corrected	$752,039.40
Tax at 12½%	$ 94,004.93
Tax previously assessed	32,546.59
Deficiency	$ 61,458.34

Adjustments to net income are as explained in prior year.

Careful consideration has been given to your protest dated December 13, 1926 and you are advised that this office holds that your association is taxable as corporation from the date of organization, April 3, 1922. Relative to option of capitalizing intangible drilling costs your corporation exercised this option and is bound by the same in accordance with Article 223, Regulations 62. The income received by you from the property owned by the City of Long Beach, California, is not exempt from Federal income taxes in accordance with S. R. 8131, Cumulative Bulletin V-1, page 22.

Payment of the tax should not be made until a bill is received from the Collector of Internal Revenue for your district, and remittance should then be made to him.

[36]

IT:CA:2554-15

Accompanying Valuation Report
by F. K. B. of March 29, 1926

ENGINEERING DIVISION—OIL & GAS VALUATION SECTION

Depletion Schedule Based on Cost and Discovery Value

Taxpayer: A. T. JERGINS TRUST (A TRUST) LONG BEACH, CALIF.
(Name) (Address)

Remarks: Acquisition 4-11-22
Discovery 7-27-22 Alamitos
Basic Date: " 1- 2-23 Brown

Lease: A. T. JERGINS—City Lease 140 Ac of Long Beach City.
(Name) (Description) Water Reservation

Value of Oil Acquisition Cost $200,000.00
Alamitos Disc. Appn. 875,984.59

Field: Signal Hill Field

Reserves: Brown " " 1,123,695.65
Alamitos 2,098,248 Bbls.
Brown 1,611,652.56 "
Alamitos $1.07 (25° B. Oil & Gas & Gasoline)

Interest Owned: 50% Lease
Other interests owned by: City of Long Beach 40% Royalty
Valuation Notes Values and Reserves as per Conference 6-8-25

Price of Oil: Brown $1.14 (26.5° B. Oil & Gas & Gasoline)
Equipment: None at acquisition
Depletable sum: As shown below

Year	Beg. of Yr.	Capital Sum Added During Yr.	Total For Yr.	Reserves Added During Yr	Total For Yr.	Production	Unit Cost	Depletion Sustained	Depletion Allowable
		Depletion on Cost plus Capitalized Intangible Development Costs							
1922	200,000.00	102,508.85	302,508.85	2,098,248.00	2,098,248.00	230,039.37	.144172	33,165.24	
to 3/9/23									
1923	269,343.61	48,259.21	317,602.82	1,611,652.56	3,472,861.19	146,688.16	.091269	13,388.23	
Remainder									
	304,214.59				3,333,173.03				
	Depletion on Discovery Value.								
1922	200,000.00	102,508.85							
		875,984.59	1,178,493.44	2,098,248.00	2,098,248.00	230,039.37	.561656	129,202.99	129,202.99
To 3/9/23									
1923	1,049,290.45	48,259.21							
		1,123,695.65	2,221,245.31	1,611,652.56	3,472,861.19	146,688.16	.638314	23,633.11	93,633.11
	2,127,612.20				3,333,173.03				

Taxpayer reported as an Association from March 10, 1923.
Statutory net income as Limitation of Depletion on Discovery Value 1922 170,861.96
" " " " " " " " " " 2-1/3 mos. 1923 121,997.96

Date 3/29/26 Engineer F K B SCHEDULE No. 1

Exhibit A—page 7

IT:CA:2554-15
A. T. Jergins Trust (Association)

SCHEDULE 1-A.

EXPLANATION OF ITEMS.

(e) Depreciation

Asset	Cost	Rate	Per Books	Corrected
Tanks	$28,063.24	10	$2,260.49	
Power Plant	25,908.63	10	2,086.93	
Buildings	8,070.29	5	325.03	
Bldg. Eqpt.	699.56	25	140.87	
Oil Lines	21,112.97	10	1,700.65	
Water Lines	3,159.91	10	254.54	
Gas Lines	3,959.49	10	318.94	
Tools General	2,727.60	33⅓	732.36	
Autos	2,238.56	25	450.78	
Steam Lines	3,336.13	10	268.72	
Tools—Oil Well	156.81	50	63.15	
Elec. Power Eqpt.	4,133.05	10	332.91	
Mach. & Eqpt.	9,999.64	10	805.55	
Total depreciation surface equip. (.8055 year)			$9,740.92	$9,740.92
Oil Wells	443,577.46	23%	102,022.81	—
Oil Wells, (Physical Equip. only):				
1922 Cost	$ 59,376.86			
1923—1/1-39 addns.	21,160.18			
1923—3/10-12/31 "	239,153.44			
	$319,690.48			
Less:				
Depn. 1922 $6,531.45				
Depn. 1923 1/1-3/9 3,145.23	9,676.68			
	$310,013.80	22.1%	—	$68,513.05
Reserves for period	4358550 Bbls.			
Production for period	963579 Bbls.			
Rate	22.1%			
Total depreciation claimed and allowable			$111,763.73	$78,253.97
			78,253.97	
Difference			$ 33,509.76	

[283]

IT:CA:2554-15 Exhibit A—page 8

A. T. Jergins Trust (Association)

SCHEDULE 3-A

EXPLANATION OF ITEMS.

(e) Depreciation

Assets	Cost	Rate	Per Books	Amount	Corrected
Tanks	$33,463.50	10%	$3,346.35		
Power Plant	30,998.43	10	3,099.84		
Buildings	8,415.59	5	420.78		
Building Equip.	776.08	25	194.02		
Oil Lines	30,982.34	10	3,098.23		
Water Lines	5,300.22	10	530.02		
Gas Lines	5,020.68	10	502.07		
Steam Lines	4,643.04	10	464.30		
Tools—Oil Well	1,832.24	50	916.12		
Tools General	5,712.07	33⅓	1,904.02		
Autos	3,892.56	25	973.14		
Elec. Power Equip	5,513.93	10	551.39		
Machry. & Equip. Genl.	46,432.15	10	4,643.22		
Total depreciation, surface equipment			$20,643.50		$20,643.50
Well Equipment	644,799.34	.497	$320,465.27		—
Oil Wells, (Physical Equip. only):					
1922 Cost	$59,376.86				
1923, 1/1-3/9 addns.	21,160.18				
1923, 3/10-12/31 "	239,153.44				
1924 "	303,244.69				
	$622,935.17				
Less: Depr. 1922	$ 6,531.45				
" 1923— 1/1-3/9	3,145.23				
" 1923— 3/10-12/31	68,513.05		78,189.73		
			544,745.44	45.7%	$248,948.67
Reserves for period	3,394,971 Bbls.				
Prod'n for period	1,552,683 Bbls.				
Rate 45.7%					
Total Depreciation claimed and allowable				$341,108.77	$269,592.17
				269,592.17	
Difference				$ 71,516.60	[39]

IT:CA-2554-15

A. T. Jergins Trust (An Association) Lessee
Long Beach, California.
Signal Hill Field.

SCHEDULE F.

VALUATION REPORT.

Organized March 10, 1923. California 500 units @ $1,000 par

Time consumed 22 hours.

Taxable years 1923 and 1924.
Depletion computed on cost and Discovery Value.
Drilling labor costs capitalized in oil.
Valuations at basic dates (Oil, Gas & Gasoline only)

A. T. Jergins—City Lease.	Date	Predecessor's Remaining Value (Cost)	Discovery Appreciation
Remaining	3-10-23	$304,214.59	$1,823,397.61
"Brown" Discovery	9-11-23		382,048.78

Depletion, Etx.

Gross Income, Oil, Gas & Gasoline

Taxable Year	Reported Returns	R A R	Form "O"	Depletion Claimed Returns	Form "O"	Form "O"	Depletion Allowable
				1924			
				Intangible development costs			Intangibles
1923				Expenses			Capitalized in oil
Oil	$712,809.10		$712,809.10)				
" Sump	1,221.84		)				
Gas	126,677.93		)	$569,800.93	Not stated	Not stated	$658,085.53
Gasoline	7,418.12		)				
Total	$848,126.99	$848,126.99	not stated)				
1924							
Oil	$1,629,605.49)		$1,625,332.44)				
King Tut	21,401.97)		21,401.97)				
Gas	208,571.48)		208,571.48)	$739,906.32	Not stated	Not stated	$771,982.99
Gasoline	75,797.88)		75,797.88)				
Total	$1,935,376.82	$1,935,376.82	$1,931,103.77)				

IT:CA:2554-15

A. T. Jergins Trust (Association)

EXHIBIT H

Net Income From Discovery Property Computed Without Allowance for Depletion.

	City of Long Beach Lease	
	1923	1924
	3/10-12/31	
Gross income, sale of oil and gas	$848,126.99	$1,935,376.82
Deductions:		
Production expense	31,015.73	68,370.33
Field expense	15,845.33	10,441.64
Proportion of General Overhead (1)	4,678.99	7,154.13
Taxes	18,190.66	35,852.58
Depreciation	78,253.97	269,592.17
	$147,984.68	$391,410.85
Net income, computed without allowance for depletion—	$700,142.31	$1,543,965.97
(1) Allocation of overhead expense:		
Total direct field expense, operation and development	$429,994.96	531,038.72
Total direct operating expense, per above	46,861.06	78,811.97
Ratio	11%	15%
Total general overhead	42,536.29	47,694.17
Proportion applicable in operating	4,678.99	7,154.13

[41]

IT:CA-2554-15 A. T. Jergins Trust (An Association)

EXHIBIT F.

Accompanying Valuation Report
by F. K. B. of

Engineering Division—Oil and Gas Valuation Section

Taxpayer: A. T. Jergins Trust (An Association)
Address: Long Beach, California

Lease Name: A. T. Jergins—City Lease
Description: 140 Ac. Long Beach (City) Water Reservation
Field: Signal Hill Field.
Interest Owned: 60% Lessee.
Other interests owned by: City of Long Beach 40% R.

Depletion Schedule based on Cost and Discovery Value
Remarks:
Basic Date: Discovery 9/11/23 "Brown"
Value of Oil: " $382,048.78
Reserves: " 718,044.60 Bbls.
Price of Oil: $0.79 (24.6° B. Oil & Gas & Gasol)
Equipment: Remaining Cost of Trust.
Depletable sum: As shown below.
Valuation Notes:
Values and Reserves as per conference 6-8-25

Year	Capital Sum Beg. of Year	Capital Sum Added During Year	Capital Sum Total For Year	Reserves Added During Year	Reserves Total For Year	Production	Unit Cost	Depletion Sustained	Depletion Allowable
Depletion on Cost plus Capitalized Intangibles Development Costs.									
3/10/23 to 12/31/23	$ 304,214.59	Remaining in Trust			$3,333,173.03				
		$383,133.90	$ 687,348.49	$1,025,377.60	4,358,550.63	$ 963,578.98	.157701	$ 151,957.37	
1924	535,391.12	452,226.75	987,226.75		3,394,971.65**	1,552,683.25	.290906	451,684.89	
	535,932.98				1,842,268.40				
Depletion on Discovery Value.									
6 Months 1923	$2,127,612.20	Cost $237,811.21	$2,365,423.41		$3,333,173.03	$ 463,211.40	.709661	$ 328,723.07	
3-2/3 Mos. 1923	2,036,700.34	Cost $145,322.69							$658,085.53
		Disc. Apprn. 382,048.78	2,564,071.81*	$1,025,377.60	$3,895,339.23	500,367.58	.658241	329,362.46	
1924	2,234,709.35	Cost 452,226.75	2,686,936.10		3,394,971.65**	1,552,683.25	.791446	1,228,864.99	771,982.99
	1,458,071.11				1,842,288.40				

*Includes 307,333 bbls. added on account Alamitos Zone oil, for which no additional value is allowable.
**Includes 18,125.89 bbls. royalty oil from "King Tut" well. No additional value and reserves allowable as to this property as same are included in discovery previously allowable.

Note:—Taxpayer reported as a Trust prior to March 10, 1923.
Statutory net income as limitation of Depletion on Discovery Value $ 700,142.31
2-2/3 Months 1923
1924 $1,543,965.97

Engineer F. K. B.

EXHIBIT C-1

TREASURY DEPARTMENT
Washington

Office of
Commissioner of Internal Revenue
IT:CA:2554-15 Nov. 16, 1926.

A. T. Jergins Trust,
Long Beach, California.

Sirs:

A review has been made of the report submitted by the Supervising Internal Revenue Agent at San Francisco, California, for the period March 10 to December 31, 1923 and the year 1924, disclosing an aggregate deficiency in tax amounting to $61,791.28.

Enclosed you will find a statement indicating adjustments proposed by this office based upon recommendations of the Revenue Agent above indicated. If you acquiesce in the proposed adjustments as shown in this letter and the accompanying statement, you are requested to execute the enclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:CA:2554-15. In the event that you acquiesce in a part of such proposed adjustments the form should be executed with respect to the items to which you agree.

If, however, you do not acquiesce, you are granted 30 days from the date of this letter within which to present a protest with the Supervising Internal

Revenue Agent, Sub-Treasury Building, at San Francisco, California, against the adjustments proposed herein. The protest and any additional statements of facts must be executed IN TRIPLICATE, under oath, and contain the following information: (a) The name and address of the taxpayer (in the case of an individual the residence, and in the case of a corporation the principal office or place of business); (b) in the case of a corporation the name of the State of Incorporation; (c) the designation by the date and symbol of the letter advising of the proposed adjustments with respect to which the protest is made; (d) the designation of the year or years involved and a statement of the amount of tax in dispute for each year; (e) an itemized schedule of the findings to which the taxpayer takes exception; (f) a summary statement of the grounds upon which the taxpayer relies in connection with each exception; and (g) in case the taxpayer desires a hearing, a statement to that effect.

If a protest is filed, any additional evidence or briefs of argument submitted will be given careful consideration, and if the Commissioner finally determines that there is a deficiency, you will be advised thereof by registered mail in accordance with the provisions of Section 274 of the Revenue Act of 1926. Should you not agree to the deficiency as finally determined by the Commissioner, you will be allowed 60 days from the date of mailing of the registered letter (not counting Sunday as the six-

tieth day) in which to file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Respectfully,

Enclosures: C. R. NASH,
Statement: Assistant to the Commissioner.
Form A
Form 882 [43]

Exhibit C-2

STATEMENT.

Year	Deficiency in Tax	
Period 3/10/23 to 12/31/23	$ 332.94	
1924	61,458.34	
Total	$61,791.28	
Period March 10, 1923 to December 31, 1923.		
Net loss return		$323,695.55
Depreciation, oil wells, disallowed		33,509.76
Drilling costs capitalized		383,133.90
Balance		$ 92,948.11
Depletion, additional		88,284.60
Net income corrected		$ 4,663.51
Exemption		2,000.00
Balance taxable at 12½%		$ 2,663.51
Tax at 12½%	$332.94	
Tax previously assessed	None	
Deficiency	$332.94	

Depreciation has been allowed in accordance with attached statements.

Drilling costs have been capitalized in accordance with Article 223, Regulations 62.

Depletion has been allowed in accordance with attached statements.

1924	
Net income return	$260,372.72
Development costs	452,226.75
Depreciation, oil wells	71,516.60
	$784,116.07
Depletion, additional	32,076.67
Net income corrected	$752,039.40
Tax at 12½%	94,004.93
Tax previously assessed	32,546.59
Deficiency	$ 61,458.34

Adjustments to net income are as explained in prior year.

Payment of tax should not be made until a bill is received from the Collector of Internal Revenue for your district, and remittance should then be made to him.

[44]

Exhibit C-3

SCHEDULE 1-A

EXPLANATION OF ITEMS.

(e) Depreciation

Asset	Cost	Rate	Per Books	Corrected
Tanks	$ 28,063.24	10	$ 2,260.49	
Power Plant	25,908.63	10	2,086.93	
Buildings	8,070.29	5	325.03	
Bldg. Eqpt.	699.56	25	140.87	
Oil Lines	21,112.97	10	1,700.65	
Water Lines	3,159.91	10	254.54	
Gas Lines	3,959.49	10	318.94	
Tools General	2,727.60	33⅓	732.36	
Autos	2,238.56	25	450.78	
Steam Lines	3,336.13	10	268.72	
Tools—Oil Well	156.81	50	63.15	
Elec. Power Eqpt.	4,133.05	10	332.91	
Mach. & Eqpt.	9,999.64	10	805.55	
Total depreciation surface equip. (.8055 year)			$ 9,740.92	$9,740.92
Oil wells	443,577.46	23%	102,022.81	—
Oil Wells (Physical Equip. only):				
1922 Cost	$ 59,376.86			
1923-1/1/39 Addns.	21,160.18			
1923-3/10-12/31 "	239,153.44			
	$319,690.48			
Less:				
Depr., 1922 $6,531.45				
" 1923				
1/1-3/9 3,145.23	9,676.68			
	$310,013.80	22.1%	—	$ 68,513.05
Reserves for period	4358550 Bbls.			
Production for period	963579 "			
Rate	22.1%			
Total depreciation claimed and allowable			$111,763.73	$ 78,253.97
			78,253.97	
Difference			$ 33,509.76	

[45]

Exhibit C-4

SCHEDULE 3-A

EXPLANATION OF ITEMS.

Assets	Cost	Rate	Amount Per Books	Amount Corrected
Tanks	$33,463.50	10%	$ 3,346.35	
Power Plant	30,998.43	10	3,099.84	
Buildings	8,415.59	5	420.78	
Building Equip.	776.08	25	194.02	
Oil Lines	30,982.34	10	3,098.23	
Water Lines	5,300.22	10	530.02	
Gas Lines	5,020.68	10	502.07	
Steam Lines	4,643.04	10	464.30	
Tools—Oil Well	1,832.24	50	916.12	
" General	5,712.07	33⅓	1,904.02	
Autos	3,892.56	25	973.14	
Elec. Power Equip.	5,513.93	10	551.39	
Machy. & Equip. Genl.	46,432.15	10	4,643.22	
Total depreciation, surface equipment			$ 20,643.50	$20,643.50
Well equipment	644,799.34	.497	$320,465.27	—
Oil Wells, (Physical equip. only):				
1922 cost	59,376.86			
1923,1/1-3/9 Addns.	21,160.18			
1923, 3/10-12/31 "	239,153.44			
1924 "	303,244.69			
		622,935.17		
Less: Depr. 1922	6,531.45			
" 1923— 1/1-3/9	3,145.23			
" 1923 3/10-12/31	68,513.05	78,189.73		
		544,745.44	45.7%	$248,948.67
Reserves for period	3,394,971 Bbls.			
Prod'n " "	1,552,683 "			
Rate	45.7%			
Total depreciation claimed and allowable			$341,108.77	$269,592.17
			269,592.17	
Difference			$ 71,516.60	

[46]

(Endorsed): Filed Sep. 26, 1927.

(Title of Court and Cause.)

ANSWER

The Commissioner of Internal Revenue, by his attorney, A. W. Gregg, General Counsel, Bureau of Internal Revenue, for answer to the petition of this petitioner, admits and denies as follows:

I, II, III. Admits the allegations of paragraphs I, II, and III of the petition.

IV. (a), (b), (c), (d), (e), (f). Denies that the Commissioner erred as alleged in paragraph IV, subparagraphs (a), (b), (c), (d), (e), and (f) of the petition or in any other manner.

(g) Admits that the Commissioner disallowed as a deduction for the period March 10 to December 31, 1923, the sum of $383,133.90, representing drilling costs. Denies that the Commissioner erred in making such adjustment.

(h) Admits that the Commissioner disallowed as a deduction for the year 1924 the sum of $452,226.75, representing development costs. Denies that the Commissioner erred in making such adjustment.

(i) Denies the assignment of error contained in paragraph IV, subparagraph (i) of the petition.

[47]

V. (1) Admits the allegations contained in paragraph V, subparagraph (1) of the petition.

(2) (A) For lack of information denies the allegations contained in paragraph V, (2), subparagraph (A) of the petition.

(B) For lack of information denies the allegations contained in paragraph V, (2), subparagraph (B) of the petition.

(C) Admits the allegations contained in paragraph V, (2), subparagraph (C) of the petition.

(D) Admits that petitioner has drilled said properties and has produced oil therefrom. Denies each and every other material allegation contained in paragraph V, (2), subparagraph (D) of the petition.

(E) Denies each and every allegation contained in paragraph V, (2), subparagraph (E) of the petition.

(3), (4), (5) Denies the allegations contained in paragraph V, subparagraphs (3), (4), and (5) of the petition.

(6) Admits that the Commissioner disallowed as a deduction for the period March 10 to December 31, 1923, the sum of $383,133.90. Denies that such amount or any part thereof represents an allowable deduction.

(7) Admits that the Commissioner disallowed as a deduction for the year 1924 the sum of $452,226.75. Denies that such amount or any part thereof represents an allowable deduction.

(8) Admits that the Commissioner determined that the petitioner in 1922 made a binding election with reference to capitalization of expenditures. Denies that such determination was erroneous or illegal.

(8) (a) For lack of information, denies the allegations contained in paragraph V, (8), subparagraph (a) of the petition. [48]

(b) Denies each and every material allegation contained in paragraph V, (8), subparagraph (b) of the petition.

VI. Denies generally and specifically each and every allegation contained in the petitioner's petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that the appeal of the petitioner be denied.

A. W. GREGG,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:
JOHN W. FISHER,
Special Attorney,
Bureau of Internal Revenue.
Sept. 21, 1927. [49]

(Endorsed): Filed May 20, 1930.

(Title of Court and Cause.)

AMENDED PETITION

By leave of the Board first had and obtained, the above named Petitioner hereby petitions for a redetermination of the deficiency set forth by the Respondent in his Notice of Deficiency, IT:CA:2554-15-60D, dated May 28, 1927, and as the basis of this proceeding alleges as follows:

I.

The Petitioner is an organized trust, created and existing under and by virtue of the laws of the State of California, with its principal place of business at Long Beach, California.

II.

Notice of deficiency, copy of which is attached hereto, marked "Exhibit A," was mailed to Petitioner on May 28, 1927.

III.

The taxes in controversy are income and profits taxes for the years 1922, 1923 and 1924, amounting to the sum of $65,953.88.

IV.

The determination of the taxes set forth in the said notice of deficiency is based upon the following errors:

(a) The Respondent erred in determining that the income derived by Petitioner from the land owned by the City of Long Beach, California, constituted taxable income within the meaning of the provisions of the Revenue [50] Acts of 1921 and 1924 and the Sixteenth Amendment to the Constitution of the United States of America.

(b) The Respondent erred in refusing to treat as non-taxable income the proceeds derived by Petitioner from the operation of the land owned by the City of Long Beach, California.

(c) The Respondent erred in refusing to hold that the provisions of the Revenue Acts of 1921 and 1924, in so far as they or either of them imposed a tax upon the income derived by Petitioner from the land owned by the City of Long Beach, California, are in conflict with the Constitution of the United States of America and the Constitution of the State of California.

(d) The Respondent erroneously and illegally disallowed as deductions for each of the years 1922, 1923 and 1924 expenditures made by Petitioner in the drilling and operation of its wells. The expenditures representing cost of well equipment were treated by Respondent as capital expenditures returnable through depreciation and the intangible expenditures representing labor, fuel, supplies, repairs and kindred items were treated by Respondent as capital expenditures returnable through depletion. If these intangible expenses are properly chargeable to capital account then they should be added to Petitioner's well cost and returned through depreciation and not through depletion.

(e) The Respondent erred in determining that Petitioner in 1922 made a binding election to capitalize expenditures made by it during the years 1922, 1923 and 1924.

(f) The Respondent erroneously failed to allow a loss for the year 1924 on account of the abandonment of one of Petitioner's wells.

V.

The facts upon which the Petitioner relies as the basis of this proceeding are as follows: [51]

1.

The A. T. Jergins Trust (a trust), Petitioner herein, was created and during the years herein involved existed and does now exist under and by virtue of a certain Declaration of Trust dated April 3, 1922, which Declaration of Trust was made and executed under and pursuant to the laws of the State of California. Petitioner was created for the purpose, among others, of acquiring oil properties and leases thereon and for the purpose of exploring, drilling for and producing and refining oil and gas.

2.

(A) The City of Long Beach, California, during the years involved herein, was and now is a body politic and corporate, duly and regularly incorporated and organized under and by virtue of the constitution and the laws of the State of California, and existing as a political subdivision of the sovereign State of California.

(B) Pursuant to the powers enumerated in its charter granted to it by the constitution and the laws of the State of California, the City of Long Beach, during the years involved in this appeal, was and now is the owner of a tract of land situated in said City of Long Beach in Los Angeles County, California. This land was acquired by the City of Long Beach in 1911 as a public and governmental

necessity in that it was acquired for the purpose of obtaining and storing water for the use of the City of Long Beach in fighting and controlling fires, sprinkling its streets, irrigating its parks and public property, flushing its sewers and maintaining sanitation, and for the general use and benefits of its inhabitants.

(C) On or about April 11, 1922, the City of Long Beach, by a written lease agreement, gave to the Petitioner the right and privilege of exploring and drilling for, extracting, obtaining, removing, marketing and [52] disposing of any and all kinds of oil and gas or oil and other hydro-carbon substances which might be found in, upon or beneath the surface of the aforesaid land. A copy of said contract of lease is attached hereto, marked "Exhibit B" and by reference thereto made a part hereof.

(D) On or before April 17, 1922, Petitioner began the drilling of a well on the land above described and was successful in finding oil and subsequent events have demonstrated the fact that this land was and is valuable for the production of oil and gas. Petitioner since April 17, 1922, has drilled several wells on this ground and during the entire time Petitioner has been engaged in the production of oil and gas on this land, the City of Long Beach has maintained supervisory power and control over the various operations of Petitioner in that the City of Long Beach, California, through its duly constituted officers, has maintained during twenty-four hours of every day, an engineer-inspector who has constantly overlooked and super-

vised the drilling operations, the recovery of oil and gas and the marketing thereof. Petitioner and the City of Long Beach, by its duly constituted officers, jointly entered into a contract with the Standard Oil Company of California for the sale of oil and gas produced on said premises and the City of Long Beach has since April, 1922, received its proportionate share of the proceeds derived from the mineral products extracted from said land, all of which money so received by it having gone into its general treasury. At no time since Petitioner began its operations on this land has Petitioner taken any important step, either in the drilling of said wells or in the marketing of the mineral products derived therefrom; that the City of Long Beach, through its constituted officers, has not exercised control over the same. Petitioner during all of this time has been and now is an agency or an instrumentality through which the said City of Long Beach has utilized its said lands in [53] performing its obligations to its citizens and the sovereign State of California.

(E) The entire income received by Petitioner during the year 1922 was derived from the mineral products extracted and sold from this city-owned land; for the year 1923 Petitioner's entire income, with the exception of approximately $500.00, was derived from the mineral products that were extracted and sold from this city-owned land; and all of Petitioner's income, with the exception of approximately $20,000.00, received by it during the year 1924 was derived from the mineral products

extracted and sold from this city-owned land. All of the income derived by Petitioner from the land owned by the City of Long Beach is, under the Constitution of the United States and the Constitution of the State of California, exempt from Federal taxation, and the provisions of the Revenue Acts of 1921 and 1924, in so far as they attempt to impose a tax thereon, are unconstitutional and void.

3.

Petitioner during the year 1922 expended, in the conduct of its business, the sum of $161,885.71, of which the sum of $59,376.86 represented expenditures made for well equipment and the balance thereof, to-wit, the sum of $102,508.85 represented intangible expenditures made for labor, supplies, repairs and incidentals in drilling its wells. The Respondent erroneously and illegally refused to allow as a deduction the said sum of $161,885.71 or any part thereof, and in capitalizing said sum the Respondent allowed depreciation on the sum of $59,376.86 expended for well equipment, but erroneously added the intangible expenditures of $102,508.85 to the capital sum returnable through depletion. In the event that the Board should sustain the Respondent in his disallowance of the deduction claimed, then the said intangible expenditures should be added to the cost of Petitioner's wells and depreciation computed thereon in the same manner as the Respondent computed depreciation on the well equipment. [54]

4.

Petitioner during the year 1923 expended, in the conduct of its business, the sum of $691,706.73, of which the sum of $260,313.62 represented expenditures made for well equipment and the balance thereof, to-wit, the sum of $431,393.11 represented intangible expenditures made for labor, supplies, repairs and incidentals in drilling its wells. The Respondent erroneously and illegally refused to allow as a deduction the said sum of $691,706.73 or any part thereof, and in capitalizing said sum the Respondent allowed depreciation on the sum of $260,313.62 expended for well equipment, but erroneously added the intangible expenditures of $431,393.11 to the capital sum returnable through depletion. In the event that the Board should sustain the Respondent in his disallowance of the deduction claimed, then the said intangible expenditures should be added to the cost of Petitioner's wells and depreciation computed thereon in the same manner as the Respondent computed depreciation on the well equipment.

5.

Petitioner during the year 1924 expended, in the conduct of its business, the sum of $755,471.44, of which the sum of $303,244.69 represented expenditures made for well equipment and the balance thereof, to-wit, the sum of $452,226.75 represented intangible expenditures made for labor, supplies, repairs and incidentals in drilling its wells. The Respondent erroneously and illegally refused to allow

as a deduction the said sum of $755,471.44 or any part thereof, and in capitalizing said sum the Respondent allowed depreciation on the sum of $303,-244.69 expended for well equipment, but erroneously added the intangible expenditures of $452,226.75 to the capital sum returnable through depletion. In the event that the Board should sustain the Respondent in his disallowance of the deduction claimed, then the said intangible [55] expenditures should be added to the cost of Petitioner's wells and depreciation computed thereon in the same manner as the Respondent computed depreciation on the well equipment.

6.

The Respondent disallowed the foregoing deductions for the intangible drilling expenses for the reason that he claims Petitioner made a binding election to capitalize said expenses. Petitioner alleges that no such binding election was made and in this respect alleges:

(a) Soon after its organization in April, 1922, Petitioner employed certain public accountants to open up for it a set of books. The Trust was originally created by three individuals and at the time of its creation, no one connected with it gave any thought or consideration to federal taxation. The accountants opened a set of books and kept, during the year 1922, a segregated account of the expenditures made for the drilling and operation of each well. Neither the trustees nor the beneficiaries at the time these

books were opened up, knew or were aware of Article 223 of Regulations 62, which in substance provides that a taxpayer may either charge to capital account or to the expense account such expenditures as are made for labor, supplies and other incidentals in connection with the drilling of an oil well.

(b) Petitioner first became aware of the provisions of the foregoing Article when it made out its first income tax return in March, 1923, at which time Petitioner directed that the intangible drilling expense be charged on its books to expense so that they could, under the regulations of the Respondent, be deducted in determining Petitioner's net taxable income. Since said time, these expenditures have been charged on Petitioner's books to the expense account and in each one of its returns filed since this time, these expenses have been deducted from Petitioner's gross income in determining its net taxable income. [56] At no time has Petitioner made a binding election to capitalize these expenditures and therefore Respondent's action in denying it the deductions claimed herein for these expenditures, is erroneous and illegal.

7.

Petitioner during the years 1923 and 1924 financed the drilling of an oil well in the State of Oklahoma and in this manner expended during the year 1923 the sum of $91,000.00 and during the year 1924 it likewise expended the sum of $41,878.39, making a sum so expended of $132,878.39. During the year

1924 the well proved to be a dry hole, whereupon during said year the well was abandoned, and Petitioner thereby sustained a loss in the total sum of $132,878.39 which constitutes a deductible loss within the meaning of the provisions of the Revenue Act of 1924.

WHEREFORE, it is prayed that:

(1) The income received by Petitioner during the years 1922, 1923 and 1924 which was derived from the proceeds of the mineral products taken from the land owned by the City of Long Beach, be held exempt from the taxes imposed by the Revenue Acts of 1921 and 1924.

(2) The provisions of the Revenue Acts of 1921 and 1924 which attempt to impose a tax on the income derived by Petitioner from the mineral products extracted by it from the land owned by the City of Long Beach, California, be held in conflict with the Constitution of the United States of America and the Constitution of the State of California.

That if the decision on the foregoing points be not decided in favor of Petitioner, that:

(3) The deductions claimed by Petitioner for the years 1922, 1923 and 1924 on account of the expenditures made by it for labor, supplies and other incidentals in connection with its operations be held to be and allowed [57] as a deduction within the meaning of the provisions of the Revenue Acts of 1921 and 1924.

(4) The Respondent's decision, holding that Petitioner had made an election to capitalize these ex-

penditures and that therefore it could not deduct them in determining its net taxable income for these years, be held to be erroneous and illegal.

(5) However, if the Board should sustain the disallowance of the deductions claimed, then Petitioner prays that the intangible drilling costs be added to Petitioner's well cost and depreciation allowed thereon instead of depletion.

Petitioner prays for general and such other and further relief as may be meet and proper in the premises.

THOMAS R. DEMPSEY,
Thomas R. Dempsey,
HOWARD W. REYNOLDS,
Howard W. Reynolds,
A. CALDER MACKAY,
A. Calder Mackay,
Attorneys for Petitioner
508 Security Bldg.
Los Angeles, California. [58]

State of California,
County of Los Angeles.—ss.

C. M. Cotton, being first duly sworn, deposes and says: That he is Vice-President of A. T. Jergins Trust, Petitioner herein; that he has read the foregoing Amended Petition and knows the contents thereof and that the same is true of his own knowledge except the matters which are therein stated up-

on information and belief and that as to those matters he believes it to be true.

C. M. COTTON.

Subscribed and sworn to before me this 19th day of May, 1930.

(Signed) ALICE FAHIEN,

My commission expires May 19, 1930.

Notary Public in and for said County and State.

A general denial was made by the Commissioner.

[59]

(Title of Court and Cause.)

AMENDMENTS TO PETITION AND ANSWERS THERETO.

(Read into record May 20 and 21, 1930)

* * * Mr. MACKAY. Now, if your Honor please, that concludes the testimony on behalf of the Petitioner, and at this time, if your Honor please, I would like to move to amend paragraph 5-2-(b) on page 3 of the petition beginning on line 19, if your Honor please, right after——no, if your Honor please, I would like to add onto the end of that paragraph (b) on page 3, this little phrase:

"Said land has always been and now is used for such purposes."

I make that motion to conform to the proof.

Mr. LEMING. And may a general denial of that amendment to the petition be entered?

The MEMBER. Yes, the motion to amend the petition is granted and the petition amended accordingly, and a general denial entered on behalf of the Respondent. [60]

Mr. MACKAY. Now, if your Honor please, in our amended petition we have claimed that the intangible drilling costs should be deducted during these years as ordinary and necessary expenses. We are abandoning that particular item and in order that the petition might be in proper form, I would like at this time to make an amendment of paragraph (d) of paragraph 4, by inserting in lieu of paragraph (d) of paragraph 4, the following:

> "The Respondent erred in determining the Petitioner's depreciation allowance in that he failed to treat as part of Petitioner's well costs, money expended in the drilling of said wells."

Then, I would like to amend paragraph (V)-3 of the petition to read as follows:

The MEMBER. Which paragraph?

Mr. MACKAY. Paragraph (V)-3 on page 5.

> "Petitioner during the year 1922 expended in the conduct of its business the sum of $161,885.71, of which the sum of $59,376.86 represented expenditures made for well equipment and the balance thereof, to-wit, the sum of $102,508.85, represented intangible expenditures made

for labor supplies, repairs and incidentals in drilling these wells. The full sum of $161,885.71 was properly capitalized by Respondent and depreciation allowed Petitioner only on the sum of $59,376.86 so expended for well equipment; the Respondent erroneously added the said intangible expenditure of $102,508.85 to the capital sum returnable through depletion and failed and neglected to [61] treat said sum as part of Petitioner's well costs, thereby denying Petitioner a deduction for depreciation thereon."

The MEMBER. The motion to amend will be granted and the petition amended accordingly.

Mr. LEMING. And a denial noted.

The MEMBER. General denial on behalf of the Commissioner will be noted.

Mr. MACKAY. I have another amendment, if your Honor please, to paragraph 4, which reads:

"Petitioner during the year 1923 expended in the conduct of its business the sum of $691,706.73, of which the sum of $260,313.62 represented expenditures made for well equipment, and the balance thereof, to-wit the sum of $431,393.11 represented intangible expenditures made for labor, supplies, repairs and incidentals in drilling these wells. The full sum of $691,706.73 was properly capitalized by Respondent and depreciation allowed Petitioner only on the sum of $260,313.62 so expended for well equipment; the Respondent erroneously added the said intangible expenditure of $431,393.11 to the capital sum returnable through depletion and failed and neglected to treat said sum as part of Peti-

tioner's well costs, thereby denying Petitioner a deduction for depreciation thereon."

I offer that as an amendment.

The MEMBER. The motion to amend will be granted and the petition amended accordingly and a general denial on behalf of the Commissioner will be entered.

Mr. MACKAY. I should also like to amend paragraph 5 on page 6, to read as follows: [62]

"Petitioner during the year 1924 expended in the conduct of its business the sum of $755,471.44, of which the sum of $303,244.69 represented expenditures made for well equipment, and the balance thereof, to-wit, the sum of $452,226.75 represented intangible expenditures made for labor supplies repairs and incidentals in drilling these wells. The full sum of $755,471.44 was properly capitalized by Respondent and depreciation allowed Petitioner only on the sum of $303,244.69 so expended for well equipment; the Respondent erroneously added the said intangible expenditure of $452,226.75 to the capital sum returnable through depletion and failed and neglected to treat said sum as part of Petitioner's well costs, thereby denying Petitioner a deduction for depreciation thereon."

The MEMBER. The motion to amend will be granted and the petition amended accordingly and a general denial on behalf of the Commissioner will be entered.

Mr. MACKAY. With that, if your Honor please, the Petitioner rests.

Mr. LEMING. If your Honor please, in view of the testimony of the principal witness here, Mr. A. T. Jergins, I want to amend the Respondent's answer and claim an additional deficiency; if the Board finds, as a matter of law that this Petitioner did not have a depletable interest in this land,—I think that is all.

The MEMBER. The answer of the Commissioner will be amended to show the claim for an additional deficiency.

Mr. LEMING. By the disallowance of depletion if the Board finds as a matter of law that the interest held by him is not depletable. [63]

A true copy teste.

B. D. GAMBLE,
Clerk U. S. Board of Tax Appeals.

22 B. T. A. ....

United States Board of Tax Appeals.

A. T. Jergins Trust, Petitioner, v. Commissioner of Internal Revenue, Respondent.

Docket No. 29940. Promulgated March 5, 1931.

1. Petitioner's income from an oil and gas lease upon lands owned by a municipal corporation is not exempt from Federal income and profits taxes.

2. Evidence held insufficient to establish the worthlessness of an oil and gas lease where it appeared that petitioner continued to pay the

rentals necessary to prevent forfeiture.

3. Expenditures for fuel, wages, repairs, hauling, etc., in connection with the drilling of oil and gas wells are capital expenses recoverable through depreciation rather than depletion.

Thomas R. Dempsey, Esq., and A. Calder Mackay, Esq., for the petitioner.

Mason B. Leming, Esq., and C. A. Ray, Esq., for the respondent.

Respondent has determined deficiencies in income and profits taxes against petitioner for the years 1922, 1923 and 1924, in the respective amounts of $1,126.62, $3,368.92 and $61,458.34. It is alleged (1) that respondent erred in determining that the income of petitioner derived from the land owned by the City of Long Beach, California, constituted taxable income, and in refusing to hold that such income was exempt from Federal tax; (2) that he erred in denying to petitioner a loss in 1924 on account of the abandonment of one of its wells; (3) that he erred in denying petitioner the right to deduct from gross income expenditures made by it for labor, fuel, supplies, repairs, and kindred items in [64] drilling and operating its wells; (4) that he erred in determining that petitioner made, in 1922, a binding election to capitalize such expenditures; and (5) that he erred in treating such expenditures as chargeable to capital account and returnable through depreciation. At the hearing petitioner abandoned

contentions (3) and (4) and respondent amended his answer and claimed an additional deficiency on the ground that petitioner had no depletable interest in the land leased by it from the city of Long Beach.

FINDINGS OF FACT.

Petitioner is an association which was organized in April, 1922, by virtue of a declaration of trust executed pursuant to the laws of California. It was created for the purpose of entering into an oil and gas lease with the city of Long Beach, hereafter referred to as the city, which is and for many years has been a municipal corporation organized under the laws of California. The charter of said city authorized it to acquire and own its own water system and to purchase, hold, lease, use, and enjoy property of every kind and description and control and dispose of the same for the common good.

For some years prior to 1911 the city had obtained its water supply from two or more independent water companies, which in turn obtained their water from subterranean sources through wells which they had bored. The water mains of these companies were made of such material that water escaped therefrom and caused mud holes in the streets, which at that time [65] were of dirt construction. When it was necessary to shut the water off from the mains, outside water would seep back into them and contaminate the water which thereafter came through them for the use of the city and its citizens. The escaping

water became stagnant and created unsanitary conditions. Tules grew along one of the main streets for about a mile and a half. The mains were of such construction that they could not resist sufficient pressure to enable the fire department to fight fires. Under these conditions the city, in 1911, after having once rejected the proposition, by popular vote authorized a bond issue for the purpose of acquiring these water systems. With the money thus obtained the city acquired about 600 acres of land about three miles north of the city and the equipment and mains of the water companies. The land so acquired has ever since been used by the city for the purpose of a water plant and for the other purposes hereafter set forth. The city obtains its water from subterranean sources. In connection with this water system the city employed in 1922, 1923, and 1924, about fifty men, whose headquarters were on the said 600 acres, and now employs about 75 men on the premises. It maintains thereon a pumping plant service department; blacksmith shop; salvage yards; a garage and a residence, all of which are used in connection with the water plant. At the time the city acquired this property there were on it three reservoirs, one of which has since been discontinued for the reason that it did not possess sufficient elevation. In addition to two oil and gas leases, of one of which petitioner is the lessee, the said tract of 600 acres has on it about 60 tenants who hold under leases or permits from [66] the city. The business

of these tenants includes airplane repair, hangars for aircraft, oil-well supplies, telephone, storage plants cracking plants, oil-skimming plants, dehydration plants, gasoline absorption plants, and farming. These leases and permits were then and are of a temporary nature; can be terminated on short notice and are made subject to the right of the city to use the property for water purposes. Many of these leases and permits were granted by the city by reason of political and business pressure brought to bear on the city authorities.

On April 11, 1922, the city, as lessor, and the petitioner, as lessee, entered into an oil lease on about 140 acres of its water system property, the pertinent parts of which read:

> WITNESSETH:
>
> Lease Term and Description of Land: For and in consideration of * * * the lessor does hereby lease, demise and let unto the lessee, and the lessee does hereby take and accept from the lessor for the term and time and for the purposes and under and in accordance with the stipulations, agreements and conditions hereinafter set forth, all that certain real property situated in the County of Los Angeles, State of California, and particularly described as follows:

[Here follows a description of the property leased with certain exceptions and incumbrances which it is not necessary to set forth.]

and finally subject to the reservation that no derrick shall be erected, no well drilled, no pipe line laid, no excavation made, no improvement placed and no work done upon the west half of Farm Lot fifty-nine (59) without first having obtained the consent of the city manager of the lessor or his successor, to the location thereof, and that no building, or other structure, shall be constructed or placed on any land within one hundred fifty (150) feet of any of the reservoirs, whether in use or not, upon said lands. [67]

This lease is granted by the lessor and accepted by the lessee for the purpose and with the exclusive right, subject to the terms, provisions and conditions hereof to explore and drill for, develop, collect, obtain, take, save, remove, market and otherwise use, enjoy and dispose of any and all kinds of oil, gas and other hydrocarbon substances which may be found in, upon or beneath the surface of said lands; together also with the rights, subject to compliance with the terms, provisions and conditions hereof, to use and enjoy the necessary rights of way for ingress and egress in, upon and across said lands for operation thereon under this lease; together also with the rights, subject to compliance with the terms, provisions and conditions hereof, to build, erect, operate, maintain and enjoy der-

ricks, rigs, boilers, tanks, tankhouses, pumping stations, pipe lines, telephone, power and light lines and other structures, apparatus and equipment suitable for use only in connection with the drilling for, developing, producing, collecting, saving, disposing of and transporting from said lands of said substances produced therein or therefrom, for the term of five (5) years from and after the date hereof, and so long thereafter as oil, gas or other hydrocarbon substances are produced, collected and saved from said lands in paying commercial quantity.

Possessory Rights: The possession by the lessee of the lands herein described, with the exception of those portions of the lands herein expressly excepted or reserved by the lessor, shall be solely and exclusively for the purposes hereof, excepting that the lessor, in addition to the reservations herein contained, reserves the right to occupy and use the same for agricultural, grazing and such other purposes as the lessor may deem necessary or desirable insofar as same shall not at any time of use interfere with any of the rights or necessary operations of the lessee; and the lessee shall conduct his operations upon said lands so as to interfere as little as possible with the reserved uses of said lands in the lessor.

Property Protection: The lessee shall, during the full term hereof, or during such part of

said term as he shall continue to occupy the herein demised lands for the purposes hereof, protect all works, structures and improvements of the lessor, together with all water stored in reservoirs or tanks, situated and located upon said lands against any and all damage and injury of whatsoever kind or character resulting from any of the operations conducted on said lands by the lessee. [68]

* * * * * * *

Drilling Obligations: The lessee shall, within five (5) days following the date hereof, actively commence the work of erecting a derrick on some portion of said lands not reserved to use of lessor as hereinabove provided for, and shall actively and continuously, in a good and workmanlike manner, complete such derrick and install therein and on said lands the necessary drilling equipment, power plant and apparatus for the drilling of an oil well and thereupon shall at once commence the actual drilling of a well for the discovery and production of oil and other hydrocarbon substances; and after commencing the drilling of such well, the lessee shall drill continuously without interruption, except such interruptions as may be caused by strike, lockout, act of God, unavoidable accident, or other cause beyond the control of the lessee, until such well shall have been drilled to a depth of thirty-seven hundred (3700) feet or until oil,

gas or other hydrocarbon substances shall be produced therefrom in paying and commercial quantity; and the lessee shall upon said condition continue to drill at least one well on said lands each year until there shall have been so drilled upon said lands at least one well for each ten (10) acres in area thereof; provided that if oil shall have been produced in paying and commercial quantity from any offset well drilled, as herein provided, during any of the said one-year periods, then and in that event the lessee shall be excused from drilling the additional well herein otherwise required to be drilled upon said lands during such one-year period.

Offset Drilling Obligations: When and as often as any well shall be drilled within a distance of six hundred (600) feet of any portion of said lands and shall produce oil at the rate of one hundred fifty (150) barrels, or more, per days of twenty-four hours, following an elapsed period of fifteen (15) days from and after the time such well shall have been brought to the point of production, the lessee shall, within forty-five (45) days thereafter commence the actual drilling of an offset well at the most advantageous place on said lands to offset the well so drilled within six hundred (600) feet of said lands, and shall drill such offset well continuously without interruption, except such inter-

ruptions as may be caused by strike, lockout, act of God, unavoidable accident, or other cause beyond the control of the lessee, until such well shall have been drilled to a depth of thirty-seven hundred (3700) feet or until oil, gas or other hydrocarbon substances shall be produced therefrom in paying and commercial quantity.

* * * * * * * [69]

Gas—Its Sale and Disposition: If gas is produced from said lands in paying and commercial quantity and the same can be sold and marketed to advantage, the lessee shall sell and market the same, in which event the lessee shall, at its own cost and expense, provide the necessary traps and other means of segregating and separating the oil from the gas and for the collection of the gas; and it shall supply the lessor, monthly, with the registered meter readings showing the production of gas and will, monthly, supply the lessor with a complete record and account of the volume of gas sold, together with a statement from the purchaser, or purchasers, of such gas showing the amount of gas received by said purchaser, or purchasers, and the price paid therefor.

* * * * * * *

Refineries and Topping Plants: The lessee shall not erect or construct upon said lands, or any part thereof, any refinery or topping plant; provided, however, that the lessee is permitted

to install a casing head gas plant thereon, at its option or election, for the purpose of converting into gasoline the gas produced on the lands.

The lessee shall not erect or construct any tanks upon said lands for the storage of oil not produced therefrom.

Taxes: The lessee shall pay all taxes and assessments which are levied or assessed upon any property which it may place on the said above described lands during the term hereof; and/or upon the oil or other hydrocarbon products stored on said lands by the lessee and not belonging to the lessor, and upon the mineral rights and interest of the lessee in said lands. All charges, taxes and assessments imposed by the State of California, United States of America, or any political subdivision of either thereof, upon said lands, or upon any part or parcel thereof, except upon the improvements placed thereon by the lessee, shall be paid in the following proportions: Forty (40%) per cent thereof by the lessor, and sixty (60%) per cent thereof by the lessee; provided, however, that the lessee shall at its sole and exclusive expense, pay and discharge all fees which are now or may hereafter be required to be paid by the State of California through the State Mining Bureau and the office of the State Oil and Gas Supervisor, or through such other department of the State of California which may be created for that purpose by legislative enactment. [70]

* * * * * * *

Rents and Royalties: The lessee shall pay to the lessor, as rent, royalty for the use of said lands for the purposes aforesaid forty (40) per cent of oil, gas and other hydrocarbon substances produced and saved from said lands, including casing head gas, except oil, or gas, or both used for fuel purposes, as herein provided; the payments royalty to be made in money or in kind, at the lessor's option. If the rental is paid in kind it shall be stored, free of charge to the lessor, in tanks to be provided by the lessee, for a period of thirty (30) days following the calendar month in which said oil is produced.

[Here follow detailed provisions respecting the payment.]

Contracts for sale of oil: The lessee shall, at least ten (10) days prior to the time when it shall sign any contract for the sale of oil or gas, or both, give written notice to the lessor of its intention to sign such contract and shall accompany such notice with a copy of the proposed contract, thus giving opportunity to the lessor to join in such contract for the sale of its royalty oil, if it shall elect so to do; and in the event that the lessor shall join in said contract, then the lessee shall be released from any and all obligations to pay the royalty of forty (40%) per cent in money, and the said contract shall provide that the purchaser under the terms of said contract shall pay the royalty of forty (40%) per cent direct to lessor.

Log and Measurements: The lessee shall keep a correct and accurate log and record of each well drilled on said lands and shall, weekly, supply the lessor with a full, true and correct copy of the log of each well then in course of drilling. * * *

The lessor shall have the right at all times, in the presence of the lessee, or of the duly authorized representative of the lessee, and in a reasonable manner, to test the accuracy of all gauges and measuring devices and to take copies of all accounts and records of production.

The lessee shall also furnish to the lessor, on or before the 20th day of each calendar month, a statement in writing, of the volume of casing head gas produced from the premises, if any, together with the price received for such product sold during the next preceding calendar month.

The lessor, through any of its agents or servants, is further granted the right to at all times inspect the works and operations of the lessee on said lands. [71]

Forfeiture: If the lessee shall be in default in the payment of the royalty or in the performance of any covenant or agreement herein contained by it to be kept or performed and shall continue in such default for a period of thirty (30) days following written notice of the respect in which such default exists or is claimed, then the lessee shall forfeit all rights granted it hereunder.

Subsequent to 1924 the above lease was amended and in 1929 it was again amended providing for the drilling of deeper wells, and the city's royalty reduced to 30 per cent. For the protection of its rights under the above lease the city maintained and maintains on the property a laboratory for the purpose of testing all oil and gas produced. It employed and employs an oil engineer whose duty it is to see that petitioner performs and does not violate its contractual duties and to see to it that the city obtains the maximum amount which can be obtained from its share in the oil and gas. The oil has been sold under a joint contract of the city and petitioner as provided in the lease. Tests are made of runs of oil; the gas is measured and petitioner's reports and the reports of the purchasers checked up. The city kept and keeps a man on the leased property at all times whose duty it is to keep the Superintendent of the Water Department constantly informed of petitioner's activities. Conferences between petitioner's representatives and the city authorities have been generally held whenever the location of a new well is to be determined. The purpose of all the above was that the city might obtain the maximum results from their share of the oil and gas.

All of petitioner's gross income for the year 1922 was derived from oil and gas produced under the above lease from the city and from its capital invested and from labor employed by it. Of petitioner's gross income for [72] 1923 the amount of $985,790.34 was derived from the same source, and

of petitioner's gross income for 1924 it derived from the same source the amount of $1,935,376.82. In his deficiency letter respondent overstated the intangible cost of developing the oil and gas leases upon the city leaseholds for the year 1923 by the amount of $91,000, and for the year 1924 in the amount of $41,878.39.

The total of the above two amounts, to-wit: $132,878.39 was expended by petitioner on oil leases in Oklahoma and, of the latter amount, $68,207.04 was spent in connection with what is hereafter referred to as the Davis and Menifee lease. By a contract dated June 14, 1923, it was agreed between petitioner and one Ramsey, who was the owner of certain oil and gas leases in the State of Oklahoma, including the Menifee and Davis leases, that Ramsey would execute an assignment to petitioner of a one-half interest in said leases, said assignment to be placed in escrow and delivered to petitioner when it had performed the requirements imposed upon it by the contract. Petitioner agreed to commence within 30 days from said date the drilling of a test well on said property and to complete the well, the well to be drilled with promptness and dispatch to a depth of 3,300 feet unless oil or gas in paying quantities should be found at a lesser depth, and was to be drilled and equipped wholly at the expense of petitioner. Any further development of the property was to be at the equal expense of both parties, and each was to be entitled to an equal share of [73] all the oil and gas produced. By a supplemental

contract dated June 27, 1923, the contract of June 14, 1923, was modified to provide that petitioner would earn the delivery of the assignment when it had performed its contract to drill a test well irrespective of whether oil and gas was found in paying quantities. By another contract dated June 14, 1923, between Ramsey and one Buttram of the first part and petitioner of the second part, as modified by a further contract between the same parties dated June 27, 1923, it was agreed that since the drilling of the test well provided for in the first contract would benefit certain other adjacent property leased by the first parties, the first parties would execute to petitioner an assignment of a one-half interest in their lease on said property, said assignment to be placed in escrow and delivered to petitioner when it had performed its contract with Ramsey. In the summer of 1924 petitioner's president, who was an oil man of long experience, visited the property referred to and found that two wells had been drilled upon the Menifee and Davis leases, both of which were dry and worthless. One had been abandoned and the drillers had ceased to work on the other and were preparing to leave. Under these conditions a contract dated July 17, 1924, was entered into between petitioner as party of the first part and Ramsey as party of the second part, which recited that party of the first part was the owner of certain leaseholds, including the Davis and Menifee leases, that by reason of a contract with Boggs Oil Corporation the party of the first part would become en-

titled to a one-half interest in another oil and gas lease when it should have drilled a test [71] well upon such leased property, that the party of the first part desired the party of the second part to drill such a test well upon such lands, that the party of the first part had theretofore expended large sums of money in drilling wells upon other leases therein described which had been non-productive and was desirous of selling to the party of the second part its right, title and interest in and to said oil and gas leases and said contract with Boggs Oil Corporation and set out the agreement of the parties in substance as follows:

(1) The party of the second part should within thirty days commence operations for the drilling of an oil well upon the lands covered by the Boggs Oil Corporation lease and continue operations until the well had been drilled to a depth of 3300 feet.

(2) That the party of the second part would pay $4,435.94, the balance due to one Mabee by the party of the first part for the drilling of a well upon one of the properties described.

(3) That the party of the first part would pay the rentals and royalties which might thereafter become due and payable under the terms and provisions of the leases mentioned in order to keep such leases in effect and avoid a forfeiture thereof.

(4) That the party of the first part does sell and convey all properties owned by the party of the first part and situated upon the lands described.

(5) That the party of the first part, upon demand, would execute and deliver to the party of the second part an assignment of its right, title and interest in and to all said leases and in and to its contract with Boggs Oil Corporation.

(6) That if, as and when oil or gas are produced in paying amounts from any of the lands described, the party of the second part pay to the party of the first part one fourth of all moneys received from the sale thereof after deducting rentals and royalties payable to the lessors until party of the second part shall pay the sum of $132,893.89, said payment to be wholly contingent upon the discovery and production of oil and gas. [75]

Petitioner had not, at the time of the hearing, May 21, 1930, received the amount of $132,893.89 referred to in the contract, or any part thereof.

During the year 1922 the petitioner expended in the conduct of its business the sum of $161,885.81, of which the sum of $59,376.86 represented expenditures made for physical equipment, and the balance thereof, to-wit, the sum of $102,508.85, represented expenditures made for wages, fuel, repairs, hauling, etc., in connection with development and drilling;

the full amount of $161,885.81 was capitalized in the determination of the deficiency for the year 1922. During the year 1923 the petitioner expended in the conduct of its business the sum of $691,706.73, of which the sum of $260,313.62 represented expenditures for physical equipment and the balance, to-wit, the sum of $431,393.11 represented expenditures for wages, fuel, repairs, hauling, etc., in connection with development and drilling; the full amount of $691,706.73 was capitalized in the determination of the deficiency for the year 1923. During the year 1924 the petitioner expended in the conduct of its business the sum of $755,471.44, of which the sum of $303,244.69 represented expenditures made for physical equipment and the balance thereof, to wit, the sum of $452,226.75, represented expenditures made for fuel, repairs, hauling, etc., in connection with development and drilling; that the full amount of $755,471.44 was capitalized in the determination of the proposed deficiency for 1924. The aforesaid amounts of $431,393.11 and $452,226.75, expended for drilling and development expenses in 1923 and 1924, respectively, and capitalized in respect of the city lease, should be reduced by the amounts of $91,000 and $41,878.39. Respondent has allowed depreciation only on the [76] above amounts expended for physical equipment and he has added the drilling and development expenses to the sums recoverable through depletion. Respondent computed petition-

er's depletion allowance for 1924 based upon cost of leaseholds and of development cost plus discovery value at the amount of $1,228,864.99, and, applying the statutory limitation, allowed a deduction of $771,982.99.

OPINION.

PHILLIPS: The first and major question presented is whether so much of the income of petitioner as was derived from its oil and gas lease on lands owned by the city of Long Beach was exempt from Federal income and profits taxes. It is pertinent to point out that we do not have before us the issue whether the income of the city from the same lease is subject to such taxation. Petitioner vigorously contends that a tax upon its income from the lease constitutes a burden on the city's right to lease and on the property itself, and is in fact a tax upon the municipality in violation of the rule that neither the Federal Government nor any State may tax an agency of the other. A similar case was carefully considered by the Board in *Coronado Oil & Gas Co.*, 11 B. T. A. 1214, where we held that income derived by a private lessee from oil and gas leases on lands owned by a State was subject to Federal taxation even though the leased lands were held for public school purposes. Petitioner seeks to distinguish the [77] *Coronado* case from this proceeding. It is urged that the lands leased by petitioner were acquired for governmental purposes, viz., to furnish water to the city and that having been so acquired

the city was bound to use them so as to produce the greatest benefit to its citizens. Conceding this to be true, this proceeding would still be governed by the *Coronado* case, where the lands leased were held for public school purposes. There is no basis for doubt that education is at least as much of a governmental function as the supply of water. Furthermore, it should be pointed out that the petitioner was not furnishing water to the city and therefore was not an instrumentality through which the city was performing that function.

The income sought to be taxed is not the income of the city from the lease. It is the income of the lessee. Neither was it derived from the pumping and distribution of water, but from an oil and gas lease on land which was originally acquired for water purposes, but which is now used by the city not only for such purposes, but for many others. Besides granting to petitioner an oil and gas lease on this property, the city has granted another such lease and there are on the property approximately 60 other tenants who hold under leases and permits, all subject to the city's water rights, who engage in business ranging from farming to oil plants and whose income under petitioner's reasoning would be exempt or at least partially exempt from income tax. The fact that the city officers may have been coerced by political or other pressure into granting these leases and permits is immaterial. All such public officers are subject to such pressure. The

fact remains that the city is largely using this property for purely commercial purposes. But whatever may be the nature of the city's functions with respect to these lands, it is clearly apparent that they are no more governmental in character than the mainte- [78] nance of a public school system as in the *Coronado* case. Petitioner's position in this respect is no stronger than that of the taxpayer in that case.

Next, it is asserted that petitioner was under the control of the city authorities to such an extent as to render it an agency or instrumentality of the city in the development of its lands. If this is true, so also is it true of all the remaining city tenants and licensees. It is not pointed out how such control can change a business into a governmental function, nor is it clearly pointed out how this conclusion is reached. It is true that in *Metcalf & Eddy v. Mitchell, supra*, the court referred to the question of control in arriving at the conclusion that the firm was not an employee, but rather an independent contractor. Here it is clear that petitioner is not an employee of the city, but is a lessee under an oil and gas lease and is liable just as any other lessee under the terms of its lease. Operating in the midst of a water plant, it was restricted to a greater extent that an ordinary lessee, but all these restrictions are set forth in the lease and are purely contractual. That the city kept strict watch in order that it might receive all to which it was entitled, does not

differentiate the city from any other lessor who was equally desirous for such returns, neither was the city's interest in its return any greater than the interest of the State of Oklahoma in securing the best returns it could from its school lands. On authority of *Coronado Oil & Gas Co., supra*, we find for respondent on this issue. See also *Bass v. Group No. 1 Oil Corp.*, 38 Fed. (2d) 483. [79]

Petitioner asserts that it lost in the year 1924 the amount of $68,207.04, which it is stipulated was expended by it in connection with the Davis and Menifee leases. The evidence on this issue, which was partly stipulated, is quite meager. By the contracts of June, 1923, Ramsey and Buttram agreed to assign to petitioner, in consideration of its drilling one test well, a one-half interest in several leases owned by Ramsey and also a one-half interest in a lease owned by Ramsey and Buttram jointly. The assignments were to be placed in escrow and to be delivered when petitioner drilled the test well. Petitioner's president testified that the assignments were never delivered, but it is recited in the contract of July 17, 1924, that petitioner was the owner of an undivided one-half interest in the leases. There is also testimony that two test wells were completed upon these premises. The conclusion seems clear that the petitioner fulfilled its contract and became entitled to receive the assignments of a one-half interest in the several leases. Whether or not the assignments were delivered seems immaterial.

The petitioner having received this one-half interest in these leases as a consideration for drilling the test well, would not be entitled to deduct such cost until it was established that the leases were worthless. The fact that two wells came in dry, coupled with the testimony of the president of the petitioner would, perhaps, have been sufficient to have established the worthlessness of these leases, were it not for the contract which was entered into between Ramsey and the petitioner on July 17, 1924. The conclusion must be drawn from this contract that both Ramsey and the petitioner, both of whom were experienced oil men, regarded the leases as still having some value. This contract provided for the assignment of all these leases to Ramsey, who agreed as a considera- [80] tion therefor to pay a balance of $4,435.95 due upon one of the wells, to drill a well upon another of the leased properties and to pay to the petitioner 20 per cent of the oil and gas recovered. The property upon which Ramsey was to drill the new well was not the same property upon which wells had been drilled by the petitioner. The petitioner contracted to make the payments necessary to keep all of the leases in existence. These undertakings, particularly the latter, indicate that the parties did not consider the leases to be worthless. It may be that they were regarded as of little value but, if the parties were willing to continue to pay the rents and royalties necessary to keep such leases alive despite two dry holes, they

evidence their opinion of some value. In a case such as this it would be more reasonable to fix the date of worthlessness as being the date when the parties refused to pay further rents and royalties.

We appreciate that this conclusion is opposed to the testimony of the president of the petitioner. That testimony undertook to state the recollection and opinion of the witness several years after the fact and appears to be contradicted by the terms of the agreement entered into on July 17, 1924. The action of the Commissioner in refusing to allow the cost of acquiring the one-half interest in these leaseholds is approved.

The final contention of petitioner is that respondent erred in adding its drilling and development expenses to the amounts recoverable through depletion. Petitioner has waived its contention that these costs are proper subjects for annual deductions and apparently concedes that they should be capitalized. We believe that this is the proper solution of the problem. Compare *Consolidated Mutual Oil Company*, 2 B. T. A. 1067, *Old Farmers' Oil Company*, 12 B. T. A. 203. Both parties agree that these [81] capital expenditures are returnable to petitioner during the life of its lease and they differ only as to the character of the deduction. Respondent has allowed it as depletion, while petitioner claims it as depreciation. Respondent has added these expenditures to amounts recoverable through depletion and has thus determined a larger deple-

tion unit. Ordinarily, where there is no difference as to the rate, it would become immaterial whether the capital cost was recovered as depreciation or as depletion. But section 234 (a) (8) of the Revenue Act of 1924 as restricted by section 204 (c) of the same act places certain limitations on the deduction for depletion while the deduction for depreciation is subject to no such restrictions. In the present case the restriction operates to deny to petitioner the full amount of the deduction for depletion to which it would otherwise be entitled. Under these conditions it becomes necessary to discuss the character of the deduction. Section 234 (a) (9) of the Revenue Act of 1921 and section 234 (a) (8) of the Revenue Act of 1924 permit the deduction in cases such as this of "a reasonable allowance for depletion and for depreciation of improvements, * * *." As we understand the stipulation, the amounts in controversy were expended in drilling wells and in operations preparatory and relating to such drilling, all of which would constitute a part of the cost of the structure recoverable through depreciation. On the other hand, the concept of the term "depletion" is the exhaustion of the mineral content of a mine or an oil well. *United States v. Ludey*, 274 U. S. 295. The precise wording of the statute indicates clearly that Congress had in mind the distinction between the exhaustion of the natural resources and the recovery of the capital invested in the improvements necessary to work the property. It cannot

be seriously contended that the exhaustion of petitioner's investment in preparing for and in drilling its wells constitutes any [82] part of the exhaustion of its oil reserves.

The Commissioner relies upon Article 223 of Regulations 62 which provides:

> Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to the capital account returnable through depletion. *If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation.* * * * (Italics supplied.)

If this regulation is susceptible of the construction which has been placed upon it in this case, it is in conflict with the provisions of the statute, which allows improvements to be depreciated. It seems to us, however, that the regulation has not been properly applied in this case. The construction used in computing the deficiency was that tangible assets which go upon the property, such as lumber, cement, casing, tubing, etc., are all charges that "are represented by physical property while other costs were not." The cost of labor for erecting the derrick or drilling the well, the fuel used in such operation, the

cost of hauling such materials are all "represented by physical property". The Commissioner in his brief recognizes that such is the case and now urges that we sustain his action upon the ground that the stipulated facts are insufficient to show what part of the amounts disallowed were represented by physical property. The stipulation shows that the Commissioner has allowed as the cost of improvements (the word used in the statute) only the amounts expended for physical equipment and has refused to treat as cost of improvements amounts expended for wages, fuel, repairs and hauling "in connection with development and drilling." This terminology excludes the idea that any part of such amount was expended in discovery or [83] exploration work or in operating the leased property. Amounts expended in development and drilling operations convey to us the impression of expenditures for improvement of the property upon which the statute permits the taxpayer to deduct depreciation. The adjustment of taxable income will be accomplished by allowing as depreciation the amounts previously treated as depletion allowances upon these expenditures.

At the hearing petitioner's president testified that he had been informed that the officers of the city were without authority to grant it a lease for a term exceeding three years, whereupon respondent amended his answer and alleged that petitioner did not have a depletable interest in the property leased. The lease was granted in April, 1922, for a term of

five years and so long thereafter as oil and gas were produced in paying quantities. During all the years involved, 1922, 1923, and 1924, the leases were operated and the city received its share of the oil and gas produced wholly at petitioner's expense. There is nothing in the record which indicates that the city has questioned petitioner's rights, much less that the city has attempted to oust it. Whether the conclusion of the witness, a layman, was or was not sound in law, we have no way of determining from the record. Under these circumstances it would be presumptuous on our part to attempt to decide a question which the city has not raised.

Upon recomputation of the deficiency, respondent's overstatement of petitioner's intangible costs attributable to its city lease should be taken into consideration.

Reviewed by the Board.

Decision will be entered under Rule 50

(Seal) [84]

[Endorsed]: Filed April 24, 1931.

(Title of Court and Cause.)

MOTION.

Comes now the respondent, by his attorney, C. M. Charest, General Counsel for the Bureau of Internal Revenue and for the reasons set forth in the annexed memorandum, which is by reference made a part hereof, moves the Board to reconsider its opin-

ion promulgated in the above entitled proceeding on March 5, 1931.

(Signed) C. M. CHAREST, (s)
C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:
MASON B. LEMING,
Special Attorney,
Bureau of Internal Revenue. [85]

MEMORANDUM IN SUPPORT OF MOTION for Reconsideration of Decision of Board in Appeal of A. T. Jergins Trust Docket No. 29940

The only point decided adversely to the respondent, in this proceeding, was in reference to the claim of the petitioner, made at the hearing, that it was entitled to depreciation on certain sums representing "intangible expenditures made for labor, supplies, repairs and incidentals." The following matters occurred in respect of this claim, as shown by the transcript:

"Mr. Mackay (Tr. p. 120): Now, if your Honor please, in our amended petition we have claimed that the intangible drilling costs should be deducted during these years as ordinary and necessary expenses. We are abandoning that particular item and in order that the petition might be in proper

form, I would like at this time to make an amendment of paragraph (d) of paragraph 4, by inserting in lieu of paragraph (d) of paragraph 4, the following:

> 'The Respondent erred in determining the Petitioner's depreciation allowance in that he failed to treat as part of Petitioner's well costs, money expended in the drilling of said wells.'

Then, I would like to amend paragraph (V)-3 of the petition to read as follows:

The Member: Which paragraph?

Mr. Mackay: Paragraph (V)-3 on page 5:

> 'Petitioner during the year 1922 expended in the conduct of its business the sum of $161,885.71, of which the sum of $59,376.86 represented expenditures made for well equipment and the balance thereof, to-wit, the sum of $102,508.85, represented intangible (Tr. p. 121) expenditures made for labor supplies, repairs and incidentals in drilling these wells. The full sum of $161,885.71 was properly capitalized by Respondent and depreciation allowed Petitioner only on the sum of $59,376.86 so expended for well equipment; the Respondent erroneously added the said intangible expenditure of $102,508.85 to the capital sum returnable through depletion and failed and neglected to treat said sum as part of Petitioner's well costs, thereby denying Petitioner a deduction for depreciation thereon.'

The Member: The motion to amend will be granted and the petition amended accordingly.

"Mr. Leming. And a denial noted.

The Member. General denial on behalf of the Commissioner will be noted.

Mr. Mackay. I have another amendment, if your Honor please, to paragraph 4, which reads: [86]

> 'Petitioner during the year 1923 expended in the conduct of its business the sum of $691,-706.73 of which the sum of $260,313.62 represented expenditures made for well equipment, and the balance thereof, to-wit the sum of $431,393.11 represented intangible expenditures made for labor, supplies (Tr. p. 122) repairs and incidentals in drilling these wells. The full sum of $691,706.73 was properly capitalized by Respondent and depreciation allowed Petitioner only on the sum of $260,313.62 so expended for well equipment; the Respondent erroneously added the said intangible expenditure of $431,393.11 to the capital sum returnable through depletion and failed and neglected to treat said sum as part of Petitioner's well costs, thereby denying Petitioner a deduction for depreciation thereon.'

I offer that as an amendment.

The Member. The motion to amend will be granted and the petition amended accordingly and a general denial on behalf of the Commissioner will be entered.

Mr. Mackay. I should also like to amend paragraph 5 on page 6, to read as follows:

> 'Petitioner during the year 1924 expended in the conduct of its business the sum of $755,-

471.44, of which the sum of $303,244.69 represented expenditures made for well equipment, and the balance thereof, to-wit, the sum of $452,226.75 represented intangible expenditures made for labor supplies repairs and incidentals in drilling these wells. The full sum of $755,-471.44 was properly capitalized (Tr. p. 123) by Respondent and depreciation allowed Petitioner only on the sum of $303,244.69 so expended for well equipment; the Respondent erroneously added the said intangible expenditure of $452,226.75 to the capital sum returnable through depletion and failed and neglected to treat said sum as part of Petitioner's well costs, thereby denying Petitioner a deduction for depreciation thereon.'

"The Member. The motion to amend will be granted and the petition amended accordingly and a general denial on behalf of the Commissioner will be entered.

Mr. Mackay. With that, if your Honor please, the Petitioner rests." (Tr. p. 123).

* * * * * * *

"Mr. Leming. * * * The Government rests, if your Honor please (Tr. 128)

Mr. Mackay. If your Honor please, I want to make one observation: Mr. Leming, when I read those amendments into our petition, setting forth the fact that the Commissioner had capitalized certain well cost equipment, now you deny that; you have never denied it in our petitions heretofore and all we are amending our petition in this respect for is

this: We were trying to claim depreciation on those items instead of depletion. [87]

Now, since you have denied that we did expend those, maybe we did not make out a case. I want to know if we can not agree under Rule 50 to make the necessary adjustments in the event the Board should hold we are entitled to have those sums added to the capital sum we are entitled to by depreciation.

Mr. Leming. I think, Mr. Mackay the deficiency letter sets those items out and we of course admit whatever the deficiency letter shows in that respect subject to the stipulation we have already made about exclusion of the $132,000.

Mr. Mackay. Oh yes.

Mr. Mackay. We want to call your Honor's attention (Tr. p. 129) to that part of the deficiency letter so that there will be no doubt about our having proved our case.

Mr. Leming. You put a copy of that in evidence, did you not,—of the deficiency letter?

Mr. Mackay. No, I did not.

Mr. Leming. I think it would be a good idea. If your Honor please, if it is agreeable to counsel I will agree to enter into a little written stipulation here agreeing what the intangible development costs are for each of these years that is represented in the deficiency letter.

The Member. That could be submitted tomorrow, I take it?

"Mr. Leming. Yes, it could.

The Member. Is there anything further to be offered at this time?

Mr. Mackay. If your Honor please, we can stipulate all of this tonight and submit it to your Honor tomorrow.

The Member. The case will be continued until 10:00 o'clock tomorrow morning; the balance of the cases set for hearing will also be continued until ten o'clock tomorrow morning.

Mr. Leming. If your Honor please, on this stipulation we have agreed to here, which we will get in form for you, I have a conference arranged with another attorney in a case (Tr. p. 130) which will come up shortly, and agreed to meet him as soon as this hearing was concluded, and personally I do not think I will get an opportunity to look at this until ten o'clock in the morning. I am quite sure some of my associates will; I thought if we could file this some time tomorrow——

The Member: Just for the purposes of the record I will mark it at ten o'clock; if you are not ready then we will wait until a little bit later. Do you wish to arrange at this time for briefs? I take it at this time the only thing that remains in the case is the filing of the stipulation.

Mr. Leming. That is true, as far as the Respondent is concerned. [88]

The Member. October 1st; is that satisfactory for briefs?

Mr. Mackay. Assuming there is no further hearing.

The Member. That is true; if we have to have a further hearing we will take care of that.

(Thereupon a recess was had in this case until the following day to permit of the filing of the stipulation: on Thursday, May 22, 1930, at 10:15 o'clock, a. m., the following further proceedings were had in (Tr. p. 131) this case):

Thursday, May 22nd, 1930.

(The hearing in this cause was resumed this day at 10:15 o'clock, a. m., as follows:)

"Mr. Leming. We have the A. T. Jergins stipulation signed and ready to be filed.

The Member. That is ready to be submitted now?

Mr. Dempsey. Yes.

Mr. Leming. It is ready to be filed.

The Member. It will be received and filed.

(The stipulation was thereupon received and stamped 'filed'.)

(The above and foregoing is all of the proceedings had and testimony heard on the hearing of the above cause; whereupon, at 10:20 o'clock, a. m., the above hearing was concluded.)"

The above mentioned stipulation reads as follows:

"It is stipulated that during the year 1922 the petitioner expended in the conduct of its business

the sum of $161,885.81, of which the sum of $59,376.86 represented expenditures made for physical equipment, and the balance thereof to-wit, the sum of $102,508.85 represented expenditures made for wages, fuel, repairs, hauling, etc., in connection with development and drilling; the full amount of $161,885.81 was capitalized in the determination of the deficiency for the year 1922.

"It is stipulated that during the year 1923 the petitioner expended in the conduct of its business the sum of $691,706.73, of which the sum of $260,313.62 represented expenditures for physical equipment and the balance, to-wit, the sum of $431,393.11 represented expenditures for wages, fuel, repairs, hauling, etc., in connection with development and drilling; the full amount of $691,606.73 was capitalized in the determination of the deficiency for the year 1923. [89]

"It is stipulated that during the year 1924, the petitioner expended in the conduct of its business the sum of $755,471.44 of which the sum of $303,244.69 represented expenditures for physical equipment and the balance thereof, to-wit, the sum of $452,226.75 represented expenditures made for fuel, repairs, hauling, etc., in connection with development and drilling; that the full amount of $755,471.44 was capitalized in the determination of the proposed deficiency for 1924.

"It has been previously stipulated at the hearing in this case that the aforesaid amounts of $431,393.11 and $452,226.75, expended for drilling and

development expenses in 1923 and 1924, respectively, and capitalized in respect of the City of Long Beach lease, should be reduced by the amounts of $91,000.00 and $41,878.39.

It is also stipulated that the respondent has allowed depreciation only on the above amounts expended for physical equipment and that he has added the drilling and development expenses to the sums recoverable through depletion."

In passing upon this point the Board said:

"The final contention of petitioner is that respondent erred in adding its drilling and development expenses to the amounts recoverable through depletion. Petitioner has waived its contention that these costs are proper subject for annual deductions and apparently concedes that they should be capitalized. We believe that this is the proper solution of the problem. Compare *Consolidated Mutual Oil Company*, 2 B. T. A. 1067, *Old Farmers' Oil Company*, 12 B. T. A. 203. Both parties agree that these capital expenditures are returnable to petitioner during the life of its lease and they differ only as to the character of the deduction. Respondent has allowed it as depletion, while petitioner claims it as depreciation. Respondent has added these expenditures to amounts recoverable through depletion and has thus determined a larger depletion unit. Ordinarily, where there is no difference as to the rate, it would become immaterial whether the capital cost was recovered as depreciation or as depletion. But

section 234 (a) (8) of the Revenue Act of 1924 as restricted by section 204 (c) of the same act places certain limitations on the deduction for depletion while the deduction for depreciation is subject to no such restrictions. In the present case the restriction operates to deny to petitioner the full amount of the deduction for depletion to which it would otherwise be entitled. Under these conditions it becomes necessary to discuss the character of the deduction. Section 234 (a) (9) of the Revenue Act of 1921 and section 234 (a) (8) of the Revenue Act of 1924 permit the deduction in cases such as this of a 'reasonable allowance for depletion and for depreciation of improvements * * *.' As we understand the stipulation, the amounts in controversy were expended in drilling wells and in operations preparatory and relating to such drilling, all of which would constitute a part of the cost of the structure recoverable through depreciation. On the other hand, the concept of the term 'depletion' is the exhaustion of the mineral content of a mine or an oil well. *United States v. Ludey*, 274 U. S. 295. The precise wording of the statute indicates clearly that Congress had in mind the distinction between the exhaustion of the natural resources and the recovery of the capital invested in the improvements necessary to work the property. It cannot be seriously contended that the exhaustion of petitioner's investment in preparing for and in drilling its wells constitutes any part of the exhaustion of its oil reserves. [90]

"The Commissioner relies upon Article 223 of Regulations 62 which provides:

> Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of well, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to the capital account returnable through depletion. *If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation* * * * (Italics supplied.)

"If this regulation is susceptible of the construction which has been placed upon it in this case, it is in conflict with the provisions of the statute, which allows improvements to be depreciated. It seems to us, however, that the regulation has not been properly applied in this case. The construction used in computing the deficiency was that tangible assets which go upon the property, such as lumber, cement, casing, tubing, etc., are all charges that 'are represented by physical property while other costs were not.' The cost of labor for erecting the derrick or drilling the well, the fuel used in such operation, the cost of hauling such materials are all 'represented by physical property.' The Commissioner in his brief recognizes that such is the case and now

urges that we sustain his action upon the ground that the stipulated facts are insufficient to show what part of the amounts disallowed were represented by physical property. The stipulation shows that the Commissioner has allowed as the cost of improvements (the word used in the statute) only the amounts expended for physical equipment and has refused to treat as cost of improvements amounts expended for wages, fuel, repairs and hauling 'in connection with development and drilling'. This terminology excludes the idea that any part of such amount was expended in discovery or exploration work or in operating the leased property. Amounts expended in development and drilling operations convey to us the impression of expenditures for improvement of the property upon which the statute permits the taxpayer to deduct depreciation. The adjustment of taxable income will be accomplished by allowing as depreciation the amounts previously treated as depletion allowances upon these expenditures."

The effect of the Board's decision, if it stands as promulgated, will be of unusual magnitude both in amount of revenue and in the number of returns and probable refund claims involved.

The respondent fully recognizes that the question is one about which differences of opinion might well arise and appreciates, also, the fact that the Board is as earnestly concerned with a correct solution of the problem as is the Treasury Department or taxpayers.

The question was considered within the Bureau in June 1928 upon a proposal to amend the regulations and I believe it would be helpful at this time to call attention to an opinion of the General Counsel made June 27, 1928, directed to the Deputy Commissioner in Charge of the Income Tax Unit, reading as follows, in so far as it relates to this point: [91]

"Reference is made to the two proposed Treasury decisions amending * * * article 223 of Regulations 69, respectively, which have been submitted to this office for review. The proposed Treasury decisions are returned herewith without the approval of this office. The reasons for disapproval will be stated, first, as to the proposed Treasury decision amending article 223, * * *.

I.

"Article 223 of Regulations 69 provides in part that development expenditures in the case of oil and gas wells 'may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion.' The proposed Treasury decision amending this article would strike out the words 'returnable through depletion' and provide in place thereof that such expenditures 'may be taken into account in determining a reasonable allowance for depreciation.' It is noticeable that the proposed Treasury decision fails to make similar consistent changes in the last half of the article. Article 223 permits development expenditures to be taken into account in determining a

reasonable allowance for depreciation only in so far as such expenditures are 'represented by physical property.' This office sees no warrant in extending the category of depreciable property to include other than physical property subject to wear and tear, which would be the effect of the proposed amendment. Furthermore, there are convincing reasons, in the opinion of this office, why the general rule of article 223 that development expenditures charged to capital account should be regarded as 'returnable through depletion' and through depletion only, should not be abrogated.

(1) The rule is one of long standing and has remained continuously in force and effect without any change or modification under a long series of revenue acts. See the first sentence in article 223 of Regulations 45 (1920 Edition) under the Revenue Act of 1918, in article 223 of Regulations 62 under the Revenue Act of 1921, in article 225 of Regulations 69 under the Revenue Act of 1924, and in article 223 of Regulations 69 under the Revenue Act of 1926.

(2) In authorizing by the Revenue Act of 1926 a depletion allowance in the case of oil and gas wells of 27½% of the gross income from the property during the taxable year not to exceed 50% of the net income (computed without allowance for depletion) from the property, Congress must be presumed to have taken into consideration what, under the existing regulations, was regarded as depletable property and the extent of the deductions allowed for the return of such property, and in the light of those con-

siderations to have determined the percentage of gross and net income from the property which would result in a fair depletion allowance in lieu of all existing allowances for the return of capital through depletion. The deduction for percentage depletion authorized by the 1926 Act was in no case to be less than a deduction for ordinary depletion. Under the circumstances it is not believed that a taxpayer should now be allowed to claim percentage depletion and at the same time to insist on withdrawing from what heretofore has been considered as depletible capital, a part of that capital for the purpose of setting it up in another capital account which is returnable other than through depletion. To permit such action would be to allow larger [92] deductions in the case of oil and gas companies than Congress intended should be allowed.

(3) Article 223 and T. D. 4025, C. B. VI-1, 75, in view of the change in the basis for depletion provided by the Revenue Act of 1926 in the case of oil and gas wells by virtue of which depletion is allowable measured by a percentage of the income from the property without regard to the amount of the depletible capital represented, made provision that taxpayers should have a new election as to the treatment of development expenditures, whether as expense or as capital, for the taxable periods ending on or after January 1, 1925. The only reason for granting this new election was the fact that taxpayers who had theretofore charged development expen-

ditures to capital account were required to recover those expenditures through depletion allowances, and, as in many cases percentage depletion gave a taxpayer with a small or no depletible capital the same depletion allowance as a taxpayer with a large depletible capital, it was thought to be unfair to compel taxpayers who had elected to charge development expenditure to capital account returnable through depletion to continue this practice after the effective date of the new provision in the 1926 Act granting percentage depletion in the case of oil and gas wells without regard, except indirectly, to the magnitude of the depletible capital represented thereby. If the proposed Treasury decision amending article 223 were promulgated, the reason for permitting the new election granted by article 223 and T. D. 4025 would be nullified.

(4) Shortly after the enactment of the Revenue Act of 1921, the construction of the proviso inserted in section 214(a)(10) and in section 234(a)(9) of the Act that the 'depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made' was given consideration by the Bureau, and the decision was reached that the 'net income from the property' referred to in the proviso should be computed without regard to development expenditures, that is, that development expenditures should not be treated as a deduction in computing the 'net income from the

property' regardless of whether the taxpayer under article 223 of Regulations 62 elected to treat such expenditures as operating expenses deductible in computing taxable income or to charge them to capital returnable through depletion. (G. C. M. 2315, Int. Rev. Bull. VI-39, p. 2.) The justification for this rather unusual decision was that if in the case of a taxpayer who charged development expenditures to expense those expenditures were regarded as reducing the 'net income from the property' so as to limit the depletion allowance, a limitation would be imposed in such cases which would not equally affect the taxpayer who elected to capitalize development expenditures and recover them through depletion because in the latter case the 'net income from the property' used as a limitation on the depletion allowance would never be reduced by any part of the capitalized development expenditures because of the statutory direction that the 'net income from the property' should be 'computed without allowance for depletion'. The argument which was believed to be compelling and to justify the decision referred to in G. C. M. 2315 as having been made shortly after the enactment of the Revenue Act of 1921 was as follows: [93]

" * * * If the taxpayer capitalized his intangible drilling and development expenses he could not be required to reduce the net income from discovery properties by the amount of such expenditures because they were returnable through depletion. This

would have the effect of maintaining the net income from the properties upon a higher level than otherwise and therefore fix a higher maximum for the limitation on discovery depletion. Where the taxpayer, on the other hand, charged the expenditures to expense rather than capitalizing them, he might be required to reduce the net income from discovery properties by the amount of such expenditures and thereby reduce the limitation upon his depletion deductions. This disparity in the treatment of two taxpayers similarly circumstanced was called to the attention of the Bureau of Internal Revenue and means were discussed for the elimination of that disparity.

> "It should be noted that in the event the taxpayer capitalized such charges, he would have been entitled to recover the amount thereof in his subsequent income tax returns through charges for depletion. In the meantime, he would be securing a much larger depletion deduction than those who had charged such items to expense originally and deducted them from gross income for the purpose of computing statutary net income because he had not reduced his net income from discovery properties by the amount of such charges."

It is readily apparent that if the proposed Treasury decision amending article 223 were adopted, the ground of the decision reached after the enactment of the Revenue Act of 1921 to disregard development expenditures, even though treated as deduct-

ible in arriving at taxable income, in determining 'the net income from the property' to be used as a limitation on discovery depletion would be vitiated, leaving the decision made by the Bureau at that time absolutely without foundation."

With all deference to the Honorable Members of the Board, may the respondent suggest, in view of the importance of the question to all concerned, that further consideration be given this issue in the light of the reasoning contained in the foregoing opinion of the General Counsel.

Attention is respectfully called to that part of the transcript of the hearing (set out above) in respect of these expenditures, upon which the petitioner, through its experienced and expert attorneys, deliberately cast its last minute claim for additional depreciation allowances. There is no evidence in the record as to the kind or character of the assets, if any, to be depreciated, the cost, the length of the term or their remaining useful life, if any, from the date of acquisition or any other fact upon which depreciation might be computed, or that any of these expenditures went into or are represented by physical property or assets subject to depreciation.

Wherefore, it is prayed that the Board give further consideration to the record, looking to a modification of its decision in this regard and that an order of redetermination be entered approving the respondent's determination of the deficiencies.

MBL:tco 4-22-30 [94]

United States Board of Tax Appeals
Washington
Division No. 11.

A. T. JERGINS TRUST,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 29940

DECISION.

(Order of redetermination.)

The Board having heretofore, under date of March 5, 1931, promulgated its findings of fact and opinion herein directing that decision be entered under Rule 50, and counsel for respondent having filed a motion for reconsideration of said findings of fact and opinion and both parties by their counsel having filed proposed recomputations of the deficiencies herein, and hearing on said motion for reconsideration and said proposed recomputations having been had pursuant to due notice and due consideration having been given to said motion for reconsideration and said proposed recomputations, it is

Ordered that said motion for reconsideration of the findings of fact and opinion be and the same is hereby denied; and it is

Further Ordered and Decided that the deficiencies in income tax for the years 1922, 1923 and 1924

are $1,126.62, $5,524.80 and $40,265.91, respectively.

Entered: July 15, 1931.

(Seal) (Signed) EDGAR J. GOODRICH,
Member.

United States Board of Tax Appeals. [95]

[Endorsed]: Filed Dec. 31, 1931.

(Title of Court and Cause.)

PETITION FOR REVIEW
of Decision of the United States Board of Tax Appeals.

To the Honorable, the Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

The A. T. Jergins Trust in support of this, its petition, filed in pursuance of the provisions of Section 1001 of the Act of Congress approved February 26, 1926, entitled "The Revenue Act of 1926" as amended by Section 605 of the Act of Congress approved May 29, 1928, entitled "The Revenue Act of 1928", for the review of the decision of the United States Board of Tax Appeals promulgated March 5, 1931, a final order of determination having been entered July 15, 1931, respectfully shows to this Honorable Court as follows:

I.
Statement of the Nature of the Controversy. Brief Statement of Facts.

The question presented in this appeal is whether the income derived by the A. T. Jergins Trust in

pursuance of its written lease with the City of Long Beach is taxable by the Federal Government.

The City of Long Beach for many years has been and now is a municipal [96] corporation organized under the laws of the State of California. For some years prior to 1911 the City of Long Beach had obtained its water supply from two or more independent water companies, which in turn obtained their water from subterranean sources. The water mains of these companies were made of such poor material that water escaped therefrom and caused mud holes in the streets which at that time were of dirt construction. When it was necessary to shut the water off from the mains, outside water would seep back into them and contaminate the water which thereafter came through them for the use of the city and its citizens. The escaping water became stagnant and created unsanitary conditions. Tules grew along the main streets for about a mile and a half. The mains were of such poor construction that they could not resist sufficient pressure to enable the city fire department to fight fires. Under these conditions the city, in 1911, after having once rejected the proposition, by popular vote, authorized a bond issue for the purpose of acquiring these water systems. With the money thus obtained the city acquired about 600 acres of land about three miles north of the city and also the equipment and mains of the water companies. The land so acquired has ever since been used by the city for the purpose of a water plant and other purposes. The

city obtains its water from subterranean sources.

In connection with the city water system the city employed in 1922, 1923 and 1924 about fifty men, whose headquarters were on the said 600 acres and now employs about seventy-five men on the premises. It maintains thereon a pumping plant, service department and other incidental plants, all of which are used in connection with the water plant.

The petitioner, A. T. Jergins Trust (a trust) was created and does now exist by virtue of a certain declaration of trust dated April 3, 1922 made under and pursuant to the laws of the State of California. The A. T. [97] Jergins Trust was created for the purpose of entering into an oil and gas lease with the City of Long Beach. Immediately after its organization and on the 11th day of April, 1922, the City of Long Beach entered into a written lease with the A. T. Jergins Trust, which gave to the trust the right and privilege of exploring and drilling for and disposing of any oil and gas and other hydro-carbon substances which might be derived from the land described in said lease which covered only approximately 140 acres of the 600 acres of land so acquired by the City of Long Beach in 1911 and used by it for the purpose of supplying water for its needs in taking care of the streets, fire protection and other incidental needs as well as the needs of the citizens of the City of Long Beach. This lease, among other things, required the A. T. Jergins Trust to carry on an extensive drilling program, and as consideration for the covenants

to be performed by the A. T. Jergins Trust it became entitled to only sixty per cent of the oil and gas and other hydro-carbon substances produced and saved from said land; the right to the balance thereof was retained by the City of Long Beach.

The City of Long Beach maintained and does now maintain on the property a laboratory for the purpose of testing all oil and gas produced. It also employed and employs an oil engineer whose duty it is to see that the A. T. Jergins Trust performs and does not violate its contractual duties and to see to it that the city obtains the maximum amount which can be obtained from its share in the oil and gas. The oil has been sold under a joint contract of the City and the A. T. Jergins Trust as provided in the lease. Tests are made of runs of oil; the gas is measured; and petitioner's reports and the reports of the purchasers are checked up by the City of Long Beach. In addition to this, the City of Long Beach kept and keeps a man on the leased premises at all times whose duty it is to keep the Superintendent of the Water [98] Department constantly informed of the activities of the A. T. Jergins Trust. Conferences between the representatives of the A. T. Jergins Trust and the city authorities have been generally held whenever the location of a new well is to be determined. The purpose of the foregoing activities of the city in supervising the activities of the A. T. Jergins Trust was that the city might obtain the maximum results from its share of the oil and gas.

All of the income of the A. T. Jergins Trust for the year 1922 was derived from oil and gas produced from the property so leased from the City of Long Beach. Of the A. T. Jergin Trust's gross income for the year 1923 the amount of $985,790.34 was derived from the same source, and of its gross income for the year 1924 it derived from the same source the amount of $1,935,376.82.

II.

STATEMENT OF PROCEEDINGS HERETOFORE HELD.

The Commissioner of Internal Revenue, respondent herein, on the 28th day of May, 1927, mailed to the A. T. Jergins Trust what is termed a deficiency letter wherein the Commissioner proposed additional taxes for the years 1922, 1923 and 1924 of the total sum of $65,953.88. In due course of time and within the sixty day period the A. T. Jergins Trust filed its appeal with the United States Board of Tax Appeals wherein it alleged among other things that its income derived from the oil properties of the City of Long Beach under and pursuant to the aforesaid lease was immune from taxation. The A. T. Jergins Trust also alleged that it had been created for the purpose of entering into an oil and gas lease with the City of Long Beach for the purpose of exploring and developing the city's property and shortly after its creation did enter into such a lease and thereafter drilled for oil and [99] gas which it discovered. Petitioner contended be-

fore the United States Board of Tax Appeals that it was an agency or instrumentality of the City of Long Beach for the purpose of developing and utilizing the city's property for and on its behalf and that inasmuch as the City of Long Beach was a municipal corporation of the State of California the income derived by the A. T. Jergins Trust as such lessee was exempt from taxation; that the A. T. Jergins Trust was an instrumentality of the sovereign State of California in the performance of its governmental functions and that therefore neither the Commissioner nor Congress had the constitutional right to impose a tax upon it on account of the income derived by the A. T. Jergins Trust from the operation of the city's property; and that the Revenue Acts, insofar as they attempted to impose a tax upon petitioner's income, were unconstitutional and void.

The Board of Tax Appeals, among other things, held that the income of the A. T. Jergins Trust derived under and pursuant to the lease with the City of Long Beach was not exempt from taxation.

III.

Designation of Court of Review.

The petitioner, being aggrieved by the said findings of fact, opinion, decision and order, and being a trust with its principal place of business in the City of Long Beach, State of California, desires a review thereof, in accordance with the provisions

of the Revenue Act of 1926, as amended by the Revenue Act of 1928, by the United States Circuit Court of Appeals for the Ninth Circuit, within which circuit is located the office of the Collector of Internal Revenue to which the said petitioner made its income tax returns for the calendar years 1922, 1923 and 1924. [100]

IV.

Assignment of Errors.

The petitioner, as a basis of review, makes the following assignment of errors:

1. The Board of Tax Appeals erred in holding that the income derived by petitioner from the land owned by the City of Long Beach, California, constituted taxable income within the meaning of the provisions of the Revenue Acts of 1921 and 1924 and the Sixteenth Amendment to the Constitution of the United States of America.

2. The Board of Tax Appeals erred in refusing to treat as non-taxable income the proceeds derived by petitioner from the operation of the land owned by the City of Long Beach, California.

3. The Board erred in refusing to hold that the provisions of the Revenue Acts of 1921 and 1924 insofar as they or either of them imposed a tax upon the income derived by petitioner from the land owned by the City of Long Beach, California, are in conflict with the Constitution of the United States of America and the Constitution of

the State of California, and therefore void.

4. The Board of Tax Appeals erred in failing to find and conclude that the A. T. Jergins Trust was, during the years involved in this appeal, an instrumentality of the City of Long Beach in the performance of its sovereign powers.

5. The Board of Tax Appeals erred in finding that petitioner's lease with the City of Long Beach was dated April 3, 1922 instead of April 11, 1922, all as shown by the lease itself. (This error is believed to be a typographical error.)

WHEREFORE, your petitioner prays that this Honorable Court may [101] review the said findings, opinion, decision and order of the United States Board of Tax Appeals and reverse and set aside the same; and that this Honorable Court direct the entry of a decision by the said Board in favor of petitioner determining that there is no deficiency in income taxes for either the years 1922, 1923 or 1924 due from petitioner, and petitioner further prays that this Honorable Court direct the Board to determine the amount of any refund or refunds that may be due petitioner on account of the reversal of the Board's decision.

Petitioner prays for such other and further relief as may seem meet and proper in the premises.

THOMAS R. DEMPSEY
Thomas R. Dempsey
A. CALDER MACKAY
A. Calder Mackay [102]

State of California,
County of Los Angeles.—ss.

A. Calder Mackay, being duly sworn, says that he is one of the attorneys for the petitioner above named and that as such is duly authorized to verify the attached Petition for Review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of the Board rendered herein; that he has read the said Petition and is familiar with the statements therein contained, and that the facts set forth therein are true to the best of his knowledge and belief and that the said petition is filed in good faith.

A. CALDER MACKAY.

Subscribed and sworn to before me this 22nd day of December, 1931.

(Seal) ALICE FABIEN,
Notary Public in and for said County and State.

My Commission Expires May 19, 1934. [103]

[Endorsed]: Filed Jan. 9, 1932.

(Title of Court and Cause.)

PETITION FOR REVIEW AND ASSIGNMENTS OF ERROR.

To the Honorable Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

NOW COMES David Burnet, Commissioner of Internal Revenue, by his attorney, G. A. Young-

quist, Assistant Attorney General, C. M. Charest, General Counsel, Bureau of Internal Revenue, and Chester A. Gwinn, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I.

That he is the duly appointed, qualified, and acting Commissioner of Internal Revenue, appointed and holding his office by virtue of the laws of the United States; that the A. T. Jergins Trust is an association, organized in April 1922 by virtue of a declaration of trust executed pursuant to the laws of California; and having its principal place of business in the city of Long Beach, California; that the income tax returns of the said association for the calendar years 1922, 1923, and 1924 were made to the Collector of Internal Revenue for the Sixth District of California whose office is located in Los Angeles, California, which is within the jurisdiction of the United States Circuit Court of Appeals for the Ninth Circuit. [104]

II.

The nature of the controversy is as follows, to-wit:

The question upon which the petitioner seeks review by this court is whether the respondent is entitled to recover capitalized intangible expenses, such as wages, fuel, repairs, hauling, etc., in connection with the exploration, development and drilling of oil wells (such expenses not being repre-

sented by physical property) through annual deductions for depletion as provided by Article 223 of Regulations 62 or through annual deductions for depreciation as decided by the Board of Tax Appeals.

The A. T. Jergins trust was at all times material to this case an association under the laws of California. It was created for the purpose of entering into an oil and gas lease with the city of Long Beach, California.

On April 11, 1922 the city of Long Beach, California as lessor and A. T. Jergins Trust as lessee entered into an oil lease on about 140 acres of a 600 acre tract owned by said city, having been acquired by it in connection with the purchase and operation of its water system. In accordance with the terms of said lease the lessee undertook to drill, explore, and otherwise develop the land so leased for the production and sale of oil, gas, and other hydrocarbon substances produced and saved from said lands and to pay the city as lessor royalties for the use of said land for the purposes aforesaid in the amount of 40% of said production therefrom. Payments of royalties were to be made in money or in kind at the lessor's option. [105]

All of respondent's gross income for the year 1922 was derived from oil and gas produced under the above lease and from its capital invested and from labor employed by it. Of respondent's gross income for 1923 the amount of $985,790.34 was derived from the same source, and of respondent's

gross income for 1924 it derived from the same source the amount of $1,935,376.82.

During the year 1922 the respondent expended in the conduct of its business the sum of $161,885.81, of which the sum of $59,376.86 represented expenditures made for physical equipment, and the balance thereof, to wit, the sum of $102,508.85, represented expenditures made for wages, fuel, repairs, hauling, etc., in connection with development and drilling; the full amount of $161,885.81 was capitalized in the determination of the deficiency for the year 1922. During the year 1923 the petitioner expended in the conduct of its business the sum of $691,706.73, of which the sum of $260,313.62 represented expenditures for physical equipment and the balance, to wit, the sum of $431,393.11, represented expenditures for wages, fuel, repairs, hauling, etc., in connection with development and drilling; the full amount of $691,606.73 was capitalized in the determination of the deficiency for the year 1923. During the year 1924 the petitioner expended in the conduct of its business the sum of $755,471.44, of which the sum of $303,244.69 represented expenditures made for physical equipment and the balance thereof, to wit, the sum of $452,226.75, represented expenditures made for fuel, repairs, hauling, etc., in connection with development and drilling; the full amount of $755,471.44 was capitalized in the determination of the proposed deficiency for 1924. By agreement of the parties, the aforesaid amounts of $431,393.11 and

$452,226.75, expended for drilling and [106] development expenses in 1923 and 1924, respectively, and capitalized in respect of the city lease, should be reduced by the amounts of $91,000 and $41,878.39. The Commissioner has allowed depreciation only on the above amounts expended for physical equipment and he has added the drilling and development expenses to the sums recoverable through depletion. The Commissioner computed respondent's depletion allowance for 1924 based upon cost of leaseholds and of development cost plus discovery value at the amount of $1,228,864.99, and, applying the statutory limitation, allowed a deduction of $771,982.99.

Upon audit of the respondent's income and profits tax returns for the years 1922, 1923, and 1924 the Commissioner determined deficiencies for said years in the respective amounts of $1,126.62, $3,368.92, and $61,458.34. Whereupon, the respondent filed a petition in the Board of Tax Appeals alleging that the Commissioner committed the following errors:

1. In determining that its income derived from the land owned by the city of Long Beach, California, constituted taxable income and in refusing to hold that such income was exempt from Federal income tax.

2. In denying the deduction of a loss in 1924 on account of the abandonment of one of its wells.

3. In denying deductions from gross income of expenditures made by it for labor, fuel, supplies, re-

pairs, and kindred items in drilling and operating its wells.

4. In determining that it made in 1922 a binding election to capitalize the expenditures referred to in error 3 above.

5. In treating the expenditures referred to in errors 3 and 4 as chargeable to capital account and returnable through depletion. [107]

At the hearing the respondent (petitioner below) abandoned alleged errors numbers 3 and 4 and the Commissioner amended his answer and claimed an additional deficiency on the ground that petitioner had no depletable interest in the land leased by it from the city of Long Beach.

The case came on for hearing before a division of the Board at Los Angeles, California, at which time the respondent waived its contention that said intangible costs were proper subjects for annual deductions as ordinary and necessary expenses and conceded that they should be capitalized.

The Board of Tax Appeals promulgated its findings of fact and decision on March 5, 1931, in which it held for the Commissioner and against the taxpayer in the first and second issues and held for the taxpayer and against the Commissioner on the fifth issue.

Thereafter, on April 24, 1931 the Commissioner of Internal Revenue, by his General Counsel, filed a motion praying that the Board reconsider its opinion promulgated in the above entitled proceeding on

March 5, 1931 with a view to a modification of its decision on the fifth issue above stated and that an order of redetermination be entered approving the respondent's determination of deficiencies.

Thereafter, on July 15, 1931 the Board entered its decision and order of redetermination in the matter denying the motion of the Commissioner for reconsideration of the Board's findings of fact and decision promulgated on March 5, 1931 and that the deficiencies in income tax for the years 1922, 1923 and 1924 are $1,126.62, $5,524.80 and $40,265.91, respectively.

III.

That said Commissioner being aggrieved by the findings of fact and by the conclusions of law contained in said decision and by the said order of [108] redetermination desires to obtain a review thereof by this honorable *court*. The Commissioner's assignment of errors are as follows:

1. The Board of Tax Appeals erred in holding that the capitalized expenditures for wages, fuel, repairs, hauling, etc., in connection with the development and drilling of oil wells not represented by physical property, were returnable to the taxpayer through annual deductions for depreciation.

2. The Board erred in its construction of Article 223 of Regulations 62 established by the Commissioner of Internal Revenue as provided by law.

3. The Board erred in failing to hold that the capitalized expenditures for wages, fuel, repairs,

hauling, etc., not represented by physical property, in connection with the development and drilling of oil wells, were returnable through annual deductions for depletion as provided by Article 223 of Regulations 62.

4. The Board erred in denying the Commissioner's motion for reconsideration and modification of its decision promulgated in this proceeding on March 5, 1931.

5. The Board erred in failing to find the deficiencies for the years 1922, 1923 and 1924 in the amounts determined by the Commissioner in his 60-day letter dated May 28, 1927.

WHEREFORE, the Commissioner petitions that the decision of the Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Ninth Circuit, that a transcript of the record be prepared in accordance with law and with the rules of said Court and transmitted to the clerk of said Court for filing; and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said Court. [109]

(Sgd) G. A. YOUNGQUIST,
Assistant Attorney General.
C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:
CHESTER A. GWINN,
Special Attorney,
Bureau of Internal Revenue.

United States of America,
District of Columbia.—ss.

C. M. Charest, being duly sworn, says that he is General Counsel of the Bureau of Internal Revenue and as such is duly authorized to verify the foregoing petition for review; that he has read said petition and is familiar with the contents thereof; that said petition is true of his own knowledge except as to the matters therein alleged in information and belief, and as to those matters he believes it to be true.

C. M. CHAREST.

Sworn and subscribed to before me this 9 day of Jan. 1932.

(Seal) MARCELLETTE M. TAYLOR,
Notary Public.

My Commission expires March 31, 1935.

CAG:teo
1-8-32

[110]

Petitioner's Exhibit No. 1, called for in the Praecipe, will be found on page 12 of the original petition, marked Exhibit "B".

(Stamped)

(U. S. Board of Tax Appeals. Div. 11. Docket 29940 Admitted in Evidence May 20, 1930 Petitioner's Exhibit 2)

A. T. JERGINS TRUST
(A Trust)
AGREEMENT
and
DECLARATION OF TRUST

KNOW ALL MEN BY THESE PRESENTS:

That this 3rd day of April, 1922, we, A. T. Jergins, R. L. Hogan and Geo. A. Le Doux, do hereby form a Business Trust, operating under this Agreement and Declaration of Trust, to be known and styled the "A. T. Jergins Trust (A Trust)", which is to continue in existence for a period of twenty (20) years from date hereof, pursuant to the provisions of this instrument.

ARTICLE I.
Office.

The principal office of this Trust shall be at Los Angeles, County of Los Angeles, State of California, and at such other place in California and elsewhere as the Trustee may determine.

ARTICLE II.
Purposes.

The general purposes of this Trust are:

(1) To engage in and carry on the business of drilling, exploring for oil, producing, refining, distilling, treating, manufacturing, piping, carrying, handling, storing, dealing in, buying and selling oils, petroleum, natural gas, asphaltum, bitumen, bitum-

inous rock and other mineral and hydro-carbon substances, and products of all other substances, and for such purpose to buy and otherwise acquire, hold, own, manage and operate refineries, pipe lines, tanks, manufactories, machinery, tank-cars, and other works, property and appliances that may be incident or auxiliary to said business or that may be deemed necessary or convenient by the Trustee;

(2) To purchase, own, sell, improve, lease and deal in real property of every kind and description: and to buy, sell, own, hold and deal in personal property of all kinds and descriptions; [111]

(3) To borrow or lend money, with or without security, and to give or take mortgages, deeds of trust and other instruments for security therefor;

(4) To carry on and transact any and all kinds of business in which natural persons may lawfully engage;

(5) To promote, maintain, do, perform, execute, acquire, own, hold or dispose of each, all or anything incidental to, or necessary, convenient or proper, in the judgment of the Trustee for the time being to carry out or perform any of the matters, things or purposes aforesaid, or incidental thereto, or connected therewith, or to exercise or acquire any rights, franchise or privileges which may be deemed necessary, requisite, useful, convenient, incidental or auxiliary to any of the purposes, objects or things herein or that in the judgment of its Trustee for the time being may tend to advance the interests of the Trust, directly or indirectly.

ARTICLE III.
Resulting Trust.

Should the Trustee of this Trust purchase real property or any interest therein, beneficial to the Trust estate and consistent with the purposes of this Trust, with the funds of the Trust estate, in such event, pursuant to Section 853 of the Civil Code of the State of California, the consideration for such purchase shall be deemed to have been paid, in law and equity, by and for the beneficiaries under this Trust, and the Trustee of this Trust shall hold said real property or interest therein to the use of the beneficiaries under this Trust, pursuant to the Provisions of this Agreement and Declaration of Trust: nothing in this Article is intended, nor shall it be construed, to create an express Trust in real property or any interest therein or to empower the Trustee of this Trust to purchase real property or any interest therein for the Trust estate.

ARTICLE IV.
Beneficial Interests.

The beneficial Interest of the Trust shall be divided into and be represented by Five Hundred (500) units of beneficial interest, and the number of units of beneficial interest may be further increased by the Trustee by Amendment of this instrument.

[112]

Issuance of Units for Labor or Real or Peersonal Property.

Subscriptions to, or purchase of the units of beneficial interest of this Trust may be paid for, wholly or partly, by cash, by labor done, by personal property or by real property or leases thereof: and the units of beneficial interest so issued shall be declared and taken to be fully paid and not liable for any further payments. And in the absence of actual fraud in the transaction, the judgment of the Trustee, as to the value of such labor, property, real estate or leases, shall be conclusive.

ARTICLE V.
Unit Certificate.

The certificate of beneficial interest when fully paid for shall be issued and signed by the Trustee, attested by the Secretary, and shall be substantially in the following form and words, to-wit:

"A. T. JERGINS TRUST
(A Trust)
The Beneficial Interest of the Trust Estate is Divided into 500 Units

CERTIFICATE OF INTEREST.

"This is to certify that.....is the owner of.....units of beneficial interest in the A. T. JERGINS TRUST, of Los Angeles, California, a Trust, transferable only on the books of the Trust

by owner thereof in person or by duly authorized attorney upon the surrender of this certificate properly endorsed.

"This certificate of interest is subject to provisions and covenants contained in the Agreement and Declaration of Trust of the A. T. Jergins Trust (A Trust), of Los Angeles, California, dated....., recorded in the office of the County Recorder of Los Angeles County, State of California, in Book....., Page..... of the Records thereof, and any amendment or amendments thereto.

"No member is liable for any debt contracted by the Trust beyond the property of the Trust in the hands of the Trustee.

"The Owner or Holder of this certificate has no authority to contract, debt, or control over the property, except as vested by the articles of this Trust.

"This certificate is the sole and only evidence of ownership. [113]

"WITNESS the signature of the Trustee of said Trust:

"Issued and signed this.....day of....., 19.....

Attest A. T. JERGINS TRUST
(A Trust)

..... By.....
Secretary Trustee"

All of the conditions and limitations set forth in the above form shall be binding upon each member, his heirs, assigns, and legal representatives, and all creditors, and such certificate shall be trans-

ferable only on the books of the Trust in accordance with this instrument.

Beneficiaries whose certificates stand in their names on the books of the Trust shall alone be considered within the terms of this instrument and receive dividends, or have the rights of owners.

Liability of Beneficiaries.

Any beneficiaries may at any time transfer or sell his unit or units or any of them, but each holder of a unit hereunto or Certificate thereof shall be held by the fact of his acceptance of it to have assented to this Trust, and to all the provisions of this instrument.

Loss of Certificate.

In case of the loss or accidental destruction or mutilation of any certificates of beneficial interest, the Trustee may cause a new certificate to be issued upon such terms as he may see fit.

ARTICLE VI.

Rights of Beneficiaries.

Beneficiaries in this Trust shall have no legal right to the Trust property held from time to time by the Trustee herein provided for, and especially shall have no right to call for any partition of the Trust property or dissolution of the Trust property of dissolution of the Trust; but the units shall be personal property carrying the right of division of the profits, and at the termination of said Trust by expiration of the period fixed for its existence,

or otherwise, the beneficiaries shall be entitled to a division of the principal and profit in due proportion to the number of units held by each. [114]

ARTICLE VII.

Death of Beneficiary.

The death, insolvency or bankruptcy of a member of the Trust, or the transfer of his interest by sale, gift, devise, descent, operation of law, or otherwise during the life of this Trust shall not work a dissolution thereof, or have any effect upon same, its operation or mode of business, nor shall it entitle his representatives, heirs or assigns to an accounting or to take any action in the courts in law, or equity, or otherwise, against the Trust, its members, Trustee, representatives, or its property or assets, or business operations, which shall remain intact and undisturbed thereby; but they shall only succeed to the right of the original member to the certificate of membership and the units it represents, subject to this instrument.

ARTICLE VIII.

Trustee.

The entire affairs of the Trust shall be managed by the Trustee, who may be a beneficiary in the Trust. The first Trustee shall be A. T. Jergins, of Los Angeles, California, who shall remain Trustee during the existence of this Trust.

ARTICLE IX.

Right to Maintain Suits.

The Trustee, in his capacity as such, may sue and be sued in any court of law or equity, or the Trust may sue and be sued in the Trust name, as provided for by the Statutes of the State of California.

ARTICLE X.

Vacancy.

Should any vacancy occur in the office of Trustee from death, resignation or removal by law, or otherwise, or should said Trustee become incapable of acting as such Trustee, a new Trustee may be appointed by a Judge of the Superior Court of the state of California, in and for the County of Los Angeles, on application of the holders of the majority of units of beneficial interest then outstanding.

Upon any changes in the office of the Trustee being made, the new Trustee after the change is made shall execute and acknowledge an instrument certifying the change made and the new Trustee shall qualify before entering upon the discharge of his duties as such by signing and acknowledging a written acceptance of the Trust and declaration that he will [115] execute the same subject to and in accordance with this instrument.

ARTICLE XI.

Acknowledgment of Certificates.

Any certificate or paper signed by the Trustee, or a copy of the record of any of the proceedings of the Trustee, which it may be deemed advisable to record in any registry of deeds, or elsewhere, may be acknowledged by any one of the parties signing in the manner at the time prescribed by law for the acknowledgment of deeds to be recorded in such registry.

ARTICLE XII.

Employment of Agents.

The Trustee may select an Advisory Board, a President, Vice President, a Secretary, Treasurer, a Manager or Managers for all or any part of the Trust's property or business, and may employ such agents, attorneys or other servants and employees, fixing their compensation and entrusting them with such authority and duties as he may deem wise.

ARTICLE XIII.

Gross and Net Income.

The Trustee shall have power to determine whether moneys or things shall, for the purpose of these presents, be considered as capital or income, and what constitutes gross income and what net

income in any year, or part of a year, and to determine the mode in which any expenses or any outgoings shall be borne as between capital and income.

ARTICLE XIV.

Dividends.

The Trustee may, from time to time, declare and pay such dividends from the earnings of the Trust as he may deem expedient and consistent with good business judgment, keeping in mind the good of the unit holders and the interest of the Trust.

ARTICLE XV.

Accumulation of Reserve or Surplus Fund.

The Trustee shall have authority to reserve in each year such sum as he deems wise for the protection of the Trust estate and business needs thereof, from the gross or net income actually collected, as a reserve [116] or surplus fund, with power to use said fund by the Trustee at any time for the maintenance and payment of dividends, for the payment of the charges of the Trustee or to treat the same or any part thereof as a surplus capital and to change his determination as to said fund, or any part thereof, from time to time, as to him may seem prudent and expedient, absolutely at his own discretion, but always subject to the terms of this Agreement and Declaration of Trust.

ARTICLE XVI.

Exemption from Personal Liability.

The property and funds of the Trust shall primarily and alone be charged with the debts, claims, covenants, warranties, contracts or contractual obligations of the Trust, or any judgment or court decree or proceeding founded thereon, for which the Trustee and all beneficiaries shall be exempted from personal liability, and for which the beneficiaries shall not be liable for any assessment whatsoever; the Trustee or his successor or successors, his agents, servants or representatives, shall have no power to bind the beneficiaries, or their heirs, executors, administrators, successors, or assigns, personally therefor, and any person, firm, corporation, co-partnership, trust, organization or aggregation whatsoever, contracting with him, or them, shall look alone to the funds and property in his hands therefor.

Insurance.

The Trustee shall, if he employs agents, or servants, in dangerous work, take out liability insurance under the laws of the State of California, insuring said agents and the Trust against loss from accident and damages; and shall pay the premiums on said insurance from the trust funds, and further comply with the laws of the State of California relating thereto.

ARTICLE XVII.

Contracting Clause.

All contracts whatsoever shall be in writing executed, in duplicate and a copy kept by the Trustee, in which shall be plainly written, printed or stamped the following clause or its equivalent, to-wit:

> "In contracting with the A. T. Jergins Trust, it is especially stipulated and agreed that no personal liability shall exist against the beneficiaries, or any of them, by reason of this contract, but the contracting parties agree to look alone to the property and assets of the A. T. Jergins Trust in the hands of the [117] Trustee for any claim or demand arising from or growing out of this contract and any judgment or decree that may be rendered thereon, and will neither hold nor attempt to hold any beneficiaries personally therefor."

ARTICLE XVIII.

Title and Conveyance of Property.

In all deeds and conveyances of the Trustee, or his successors, it shall be set forth in said grant or conveyance or transfer or paper or bill-of-sale, or other written evidence of holding that he holds only as Trustee for the said Trust and not for himself, to be held in trust specifically for the A. T. Jergins Trust, to be held also strictly in compliance with this instrument.

The title to all property acquired and to be acquired from time to time by this Trust and all investments made shall be conveyed to and in the name of the Trustee as such, the successor or successors of him under this Agreement and Declaration of Trust for and on behalf of this Trust.

ARTICLE XIX.
Amendment.

The Trustee may at any time, for the protection and best interests of the Trust, amend this Declaration, provided such amendment shall not change the purposes of this Trust or in any way effect, modify or change the liability of the Trustee or beneficiaries. Each amendment as aforesaid shall be in writing signed, certificate and acknowledged by the Trustee and shall be filed and recorded, and said Amendment as recorded shall constitute conclusive proof of the facts thereby shown.

IN WITNESS WHEREOF, we have hereunto set our hands this the 3rd day of April, 1922.

A. T. JERGINS,
K. L. HOGAN,
GEORGE LE DOUX. [118]

State of California,
County of Los Angeles.—ss.

Before me, Alice W. Wadsworth, a Notary Public in and for Los Angeles County, California, on this

day personally appeared R. L. Hogan and Geo. A. Le Doux, known to me to be the persons whose names are subscribed to the above and foregoing instrument, and each for himself acknowledged that they executed the same for the purposes and consideration therein expressed.

Given under my hand and seal of office this 3rd day of April A. D. 1922.

(Seal) ALICE M. WADSWORTH,
Notary Public in and for the County of Los Angeles, State of California.

State of California,
County of Los Angeles.—ss.

Know All Men by These Presents: That I, A. T. Jergins, of Los Angeles, California, hereby declare that I accept the Trusteeship of the Trust hereinbefore formed, the same being known as the A. T. Jergins Trust (A Trust), and I further declare that I will hold, manage and control the funds of the said Trust estate by me now or hereafter received on account of the said Trust, and the income, profits, rents and issues therefrom, in trust, during the continuance of the said Trust pursuant to and in accordance with the foregoing Agreement, and Declaration of Trust, the provisions and Articles of which I here repeat and make a part hereof as though fully set out in this Declaration of acceptance of said Trust.

Witness my hand this 3rd day of April, 1922.

A. T. JERGINS.

State of California,
County of Los Angeles—ss.

Before me Ralph H. Clock, a Notary Public in and for Los Angeles County, State of California, on this day personally appeared A. T. Jergins, known to me to be the person whose name is subscribed to the foregoing acceptance of Trust, and he acknowledged to me that he executed the same.

Given under my hand and seal of office this the 3rd day of April, 1922.

RALPH H. CLOCK,
Notary Public in and for the County of Los Angeles, State of California. [119]

[Endorsed]: Filed February 4, 1932.

(Title of Court and Cause.)

PRAECIPE FOR TRANSCRIPT OF RECORD.

To the Clerk of the United States Board of Tax Appeals:

You are requested to prepare and transmit to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit a transcript of record in the above entitled case and to include therein certified copies of the following documents:

1. The docket entries of proceedings before the Board.
2. All pleadings before the Board including:
   (a) Original petition filed, amended petition and amendments thereto which were offered and received by the Board during the hearing.

(b) Commissioner's original answer.

(c) Have record show denials to amendments made by petitioner at the hearing.

3. Petitioner's Exhibit No. 1 being Declaration of Trust of the A. T. Jergins Trust as amended and also copy of the lease between the City of Long Beach and the A. T. Jergins Trust.

4. Petitioner's Exhibit No. 2, certified copy of the Declaration of Trust of A. T. Jergins Trust.

5. Findings of Fact, preliminary statement thereto and opinion of the Board promulgated March 5, 1931.

6. Motion of the respondent for reconsideration of the Board's opinion filed April 24, 1931.

7. Board's decision and order of re-determination entered July 15, 1931. [120]

8. Petition for Review filed by petitioner below.

9. Petition for Review filed by respondent below.

10. This Praecipe.

The foregoing to be prepared, certified and transmitted on or before March 1, 1932, as required by law and the rules of the United States Circuit Court of Appeals for the Ninth Circuit.

AGREEMENT TO PRAECIPE.

We hereby agree that the above and foregoing Praecipe is correct; that the records, documents, papers and proceedings therein set forth are sufficient for a complete record in this cause on appeal, and we hereby adopt the foregoing as a list designated by each of the parties to this cause to com-

plete said transcript, and we hereby waive the issuance and service of notice upon any party hereto, and agree that said Praecipe shall be obeyed by, and acted upon by the Clerk as fully and to all intents and purposes in the same manner as if said Praecipe had been regularly filed and a true copy thereof served upon each party hereto.

(Sgd) THOMAS R. DEMPSEY,
Thomas R. Dempsey,
Thomas R. Dempsey,
(Sgd) A. CALDER MACKAY,
A. Calder Mackay,
A. Calder Mackay,
Attorneys for Petitioner.
(Sgd) C. M. CHAREST,
General Counsel, Bureau of Internal Revenue.
Attorney for Respondent.

C A S

Dated this 4th day of February, 1932. [121]

(Title of Court and Cause.)

CERTIFICATE.

I, B. D. Gamble, Clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages 1 to 121, inclusive, contain and are a true copy of the transcript of record, papers and proceedings on file and of record in my office as called for by the

Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 20th day of February, A. D. 1932.

(Seal) B. D. GAMBLE, Clerk.

[Endorsed]: No. 6768. United States Circuit Court of Appeals for the Ninth Circuit. A. T. Jergins Trust, Petitioner, vs. Commissioner of Internal Revenue, Respondent, and Commissioner of Internal Revenue, Petitioner, vs. A. T. Jergins Trust, Respondent. Transcript of the Record. Upon Petitions to Review an Order of the United States Board of Tax Appeals.

Filed March 1, 1932.

PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

180 UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 6768

A. T. JERGINS TRUST

vs.

COMMISSIONER OF INTERNAL REVENUE

AND

COMMISSIONER OF INTERNAL REVENUE

vs.

A. T. JERGINS TRUST

UPON PETITIONS TO REVIEW AN ORDER OF THE UNITED STATES BOARD OF TAX APPEALS

Proceedings had in the United States Circuit Court of Appeals for the Ninth Circuit

181 At a stated term, to wit, the October term, A. D. 1931, of the United States Circuit Court of Appeals for the Ninth Circuit, held in the courtroom thereof, in the city and county of San Francisco, in the State of California, on Wednesday the eighth day of June in the year of our Lord one thousand nine hundred and thirty-two.

Present: Honorable Curtis D. Wilbur, senior circuit judge, presiding; Honorable William H. Sawtelle, circuit judge; Honorable Frank H. Norcross, district judge.

A. T. Jergins Trust, vs. Commissioner of Internal Revenue and Commissioner of Internal Revenue vs. A. T. Jergins Trust. No. 6768

Order of submission

Ordered, petitions to review in above cause argued by Mr. A. Cader Mackay, counsel for A. T. Jergins Trust, and by Mr. G. A. Youngquist, Assistant United States Attorney General, counsel for the Commissioner of Internal Revenue, and submitted to the court for consideration and decision.

182 I hereby certify that the foregoing is a full, true, and correct copy of an original order made and entered in the within-entitled ———

Attest my hand and the seal of the United States Circuit Court of Appeals for the Ninth Circuit, at the city of San Francisco, in the State of California, this ——— day of ———, A. D. 19—.

Clerk, U. S. Circuit Court of Appeals for the Ninth District.

(Indorsed:) No. ———. United States Circuit Court of Appeals, Ninth Circuit. Certified copy of order.

183 At a stated term, to wit, the October term, A. D. 1931, of the United States Circuit Court of Appeals for the Ninth Circuit, held in the court room thereof, in the city and county of San Francisco, in the State of California, on Thursday the eighth day of September, in the year of our Lord one thousand nine hundred and thirty-two.

Present: Honorable Curtis D. Wilbur, senior circuit judge, presiding; Honorable William H. Sawtelle, circuit judge.

A. T. Jergins Trust vs. Commissioner of Internal Revenue, and Commissioner of Internal Revenue vs. A. T. Jergins Trust. No. 6768.

Order directing filing of opinion and filing and recording of judgment

By direction of the court, *ordered* that the typewritten opinion this day rendered by this court in above cause be forthwith filed by the clerk and that a judgment be filed and recorded in the minutes of this court in accordance with the opinion filed.

184 I hereby certify that the foregoing is a full, true, and correct copy of an original order made and entered in the within-entitled ———.

Attest my hand and the seal of the United States Circuit Court of Appeals for the Ninth Circuit, at the city of San Francisco, in the State of California, this ——— day of ———, A. D. 19—.

Clerk, U. S. Circuit Court of Appeals for the Ninth District.

(Indorsed:) No. ———. United States Circuit Court of Appeals, Ninth Circuit. Certified copy of order.

185 In the United States Circuit Court of Appeals for the Ninth Circuit

A. T. Jergins Trust, petitioner, vs. Commissioner of Internal Revenue, respondent, and Commissioner of Internal Revenue, petitioner, vs. A. T. Jergins Trust, respondent. No. 6768

Upon petitions to review an order of the United States Board of Tax Appeals

Before: WILBUR and SAWTELLE, Circuit Judges, and NORCROSS, District Judge

WILBUR, Circuit Judge: Petitioner seeks to review the determination of the United States Board of Tax Appeals upon a determination by the Commissioner of Internal Revenue proposing deficiencies in income taxes for the calendar years 1922, 1923, and 1924. The Board of Tax Appeals rejected the contention of the petitioner that it was exempt from income tax and sustained its contention with reference to the manner of the determination of the depreciation and depletion items. Petitioner appeals from the former, and the commissioner from the latter, part of the decision. If the contention of the A. T. Jergins Trust is sustained it will be unnecessary to consider the commissioner's petition. We will refer throughout to the A. T. Jergins Trust as "the petitioner," and to the Commissioner of Internal Revenue as "the respondent" or "the commissioner."

186 The facts are stated in the opinion of the Board of Tax Appeals and are not in dispute. We will state the salient facts and refer to the findings of the Board of Tax Appeals for a more detailed statement.

In 1911 the city of Long Beach issued bonds and with the proceeds thereof purchased the water system which had theretofore been furnishing the city and the inhabitants thereof with water. It is stated in the opinion and emphasized in the brief on behalf of the city that the acquisition of this waterworks was made necessary by reason of the unsanitary condition of the water mains and pipe lines resulting from rust and decay which permitted the water to escape, and after becoming contaminated, to return to the pipes of the distributing system. We mention this fact but attach no importance to it. Among the assets thus purchased by the city was a tract of 600 acres of water-bearing land. This land was the source of all the water used by the city's distributing system. The water was obtained by sinking wells to a subterranean supply. Part of the water procured and distributed was used for fire protection. Some years later oil was discovered in the vicinity of the water-bearing land of the city and later oil was successfully developed and produced upon said land. On April 11, 1922, the city, as lessor, entered into a lease with the petitioner for about 140 acres of its water-bearing land

which was then, and is still, used for the procuring of water for the city and its inhabitants. It is sufficient, with reference to this lease, to state that it is an ordinary lease for the development of oil providing that the oil produced by the lessee should be divided in the proportion of forty per cent to the city and sixty per cent to the lessee. The lessee was required to pay all the expenses of exploration and development. With reference to the payment of taxes the lease stipulated as follows:

"Taxes: The lessee shall pay all taxes and assessments which are levied or assessed upon any property which it may place on the said above-described lands during the term hereof; and/or upon the oil or other hydrocarbon products stored on said lands by the lessee and not belonging to the lessor, and upon the mineral rights and interests of the lessee in said lands. All charges, taxes, and assessments imposed by the State of California, United States of America, or any political subdivision of either thereof, upon said lands, or upon any part or parcel thereof, except upon the improvements placed thereon by the lessee, shall be paid in the following proportions: Forty (40%) per cent thereof by the lessor, and sixty (60%) per cent thereof by the lessee; provided, however, that the lessee shall at its sole and exclusive expense, pay and discharge all fees which are now or may hereafter be required to be paid by the State of California through the State mining bureau and the office of the State oil and gas supervisor, or through such other department of the State of California which may be created for that purpose by legislative enactment."

The surface of the land is used for a variety of purposes. In connection with the water system the city employed about 50 men whose headquarters were on the 600 acres. It maintains thereon a pumping plant, service department, blacksmith shop, salvage yard, a garage and residence, all of which are used in connection with the water plant. In addition to two oil and gas leases, of one of which petitioner is the lessee, the said tract of 600 acres has on it about 60 tenants who hold under leases or permits from the city. The business of these tenants includes airplane repair, hangars for aircraft, oil-well supplies, telephone, storage plants, cracking plants, oil-skimming plants, dehydration plants, gasoline absorption plants, and farming. These leases and permits were then and are of a temporary nature; can be terminated on short notice and are made subject to the right of the city to use the property for water purposes. While a large amount of revenue has been derived by the city from its water-bearing lands as royalty upon the oil produced therefrom, it is clear that such production is altogether incidental to the main purpose and use of the land. We are not, therefore, dealing with a purely business venture in which the city, for the mere purpose of producing revenue for its treasury, engages upon business entirely distinct from its governmental functions.

The general principles with relation to the right of the Federal Government to tax the instrumentalities of the State, and vice versa, are well settled and have been applied in a great many cases by both State and Federal courts. The only difficulty is in the application of these general principles to the unique situation shown by the record in the case at bar. We are not, however, left solely to the application of these general principles for the determination of the ques-
287 tions involved in this case. The Supreme Court has recently had occasion to consider a number of similar leases and to determine the right of the State or Federal Government to tax the income derived therefrom by the lessee. In the most recent of these cases, decided April 11, 1932, Burnet v. Coronado Oil & Gas Co., 285 U. S. 393, 76 L. Ed. 590, the Supreme Court passed upon the power of the Federal Government to tax such proceeds derived from school lands belonging to the State of Oklahoma, and held that the Federal Government had no power to tax such income so derived. In this opinion the Supreme Court affirmed the decision of the Court of Appeals of the District of Columbia reversing a decision of the Board of Tax Appeals which sustained the Commissioner of Internal Revenue in the assessment of income taxes upon income so derived by the lessee. In the case at bar the Board of Tax Appeals predicated its conclusion in part upon its own decision in the Coronado Oil & Gas Company v. Commissioner, subsequently reversed by the Supreme Court in Burnet v. Coronado Oil & Gas Company, supra. One of the first cases dealing with this subject is Gillespie v. Oklahoma, 257 U. S. 501. A similar problem was presented in Group No. 1 Oil Corporation v. Bass, 283 U. S. 279. It must be taken as established by Gillespie v. Oklahoma, supra, Burnet v. Coronado Oil & Gas Co., 285 U. S. 393, 76 L. Ed. 590, that where oil is thus produced from land held by the State or Nation for governmental purposes, the income thus derived from the land of the State or Nation can not be taxed by the Nation or State, respectively. This is conceded by the commissioner. In the case of Gillespie v. Oklahoma, supra, the lands in question were held in trust by the Federal Government for the Indians. Oil leases of these lands were entered into by the Government in pursuance of its trust. In the case of Burnet v. Coronado Oil & Gas Co., supra, the lands were public school lands donated by the Federal Government to the State government for the purpose of maintaining schools, and the proceeds derived from the sale of oil therefrom by the State, were utilized for this confessedly governmental purpose. The commissioner contends, however, that the city of Long Beach in engaging in the business of procuring water for its inhabitants and incidentally in procuring income from its water-bearing lands in the shape of oil royalties, was acting in a proprietary rather than in a governmental capacity, and that, therefore, the constitutional principles which prevent the taxation by the Nation of the property of a State or municipality do not apply to the taxation of such an enterprise so conducted. If this argument were

valid it would seem equally applicable to the taxation of the water-bearing and oil-bearing land and to the portion of the income derived by the city therefrom by the sale of its proportion of the royalty oil, that is to say, if the taxes were constitutional, permissible because they do not interfere with the sovereign rights of the State exercised through a municipality because the municipality was not acting in a governmental but in a proprietary capacity, the right of taxation would exist as to the property itself and the income derived therefrom, provided, of course, that appropriate legislation were adopted for the direct taxation of land. As we understand it, it is not contended by the commissioner that the forty per cent royalty paid to the city is taxable as income derived by it from its lands held in a proprietary capacity, nor, indeed, do we see how such a claim could be made in view of the early decision of the Supreme Court of the United States in U. S. v. Baltimore & Ohio Ry. Co., 17 Wall. 322, wherein the Supreme Court held that the revenue derived by a State from bonds of the B. & O. Ry. Co., owned by it, were not taxable by the Federal Government, although the bonds were issued to the city to secure the repayment to the city of $5,000,000 loaned by the city to the B. & O. Ry. Co., to enable it to extend its facilities for transportation with a view of aiding the city in securing a portion of the commerce flowng from the West to the East. The general purpose of the city of Baltimore in purchasing the bonds of the Baltimore & Ohio Railway Company was much less closely related to the governmental functions of the city than the acquisition by the city of Long Beach of water-bearing lands and a water-distributing system for the inhabitants thereof, and for their fire protection. In Pollock v. Farmers Loan & Trust Co., 157 U. S. 429, the Supreme Court had under consideration the validity of the income tax law in two aspects pertinent to the considerations involved in the case at bar. The first one involved the question as to whether or not the tax upon the income derived upon real estate was a direct tax upon the real estate and therefore required by the Constitution to be apportioned among the States in proportion to the population thereof. Chief Justice Fuller, in discussing that question, stated, at p. 580:

" Unless, therefore, a tax upon rents or income issuing out of lands is intrinsically so different from a tax on the land itself that it
188 belongs to a wholly different class of taxes, such taxes must be regarded as falling within the same category as a tax on real estate eo nomine. The name of the tax is unimportant. The real question is, is there any basis upon which to rest the contention that real estate belongs to one of the two great classes of taxes and the rent or income, which is the incident of its ownership, belongs to the other? We are unable to perceive any ground for the alleged distinction. An annual tax from the annual value or annual user of real estate appears to us the same in substance as the annual tax on real estate which would be paid out of the rent or income. This law taxes the income received from land, and the growth or produce of

the land. Mr. Justice Paterson observed in Hylton's case, 'Land, independently of its produce, is of no value,' and certainly had no thought that direct taxes were confined to unproductive land."

In dealing with the question of tax upon the income derived from municipal bonds it is held in the same case that such a tax is in effect a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution. This would be true, of course, regardless of the purpose for which the bonds were issued and without reference to the question of whether or not the bonds were issued by the city or State for the purpose of acquiring property to be held by it in its proprietary rather than governmental capacity. These views were adhered to by the Supreme Court on rehearing, 158 U. S. 601. It is thoroughly established that the public lands of the United States which are held by it in a proprietary capacity are not taxable by the State. Irwin v. Wright, 258 U. S. 228; Van Brocklin v. Tenn., 117 U. S. 151; Wisconsin Central R. R. Co. v. Price, 133 U. S. 496; Lee v. Osceola Imp. Dist., 268 U. S. 644, 645. It is clear, we think, that a tax by the Federal Government upon land owned by the city, whether in its proprietary or governmental capacity, would be unconstitutional, and that a tax upon income derived by the city from lands held in a proprietary or governmental capacity would be equally obnoxious to the Constitution. It may be, however, that in dealing with the rights of third parties who have obtained income from city lands a distinction may be drawn between income derived from lands held in a governmental capacity and those held in a proprietary capacity. This seems to be indicated by the Supreme Court in Burnet v. Coronado Oil & Gas Co., supra, in which Mr. Justice McReynolds, speaking for a majority of the court, said:

"We are disposed to apply the doctrine of Gillespie v. Oklahoma strictly and only in circumstances closely analogous to those which it disclosed."

In denying the power of the Federal Government to tax the income derived from the school lands of the State of Oklahoma, he said:

"* * * that to tax the fruits of the lease would burden her in the performance of maintaining such schools."

No case, however, is cited by the commissioner sustaining a similar tax upon the ground that the property involved was held by the State or its instrumentalities in a proprietary, rather than a governmental, capacity. The commissioner relies upon the decision of South Carolina v. United States, 199 U. S. 437, dealing with the power of the Federal Government to require the payment of a license fee from the dispensaries of alcoholic liquor and holding that such payment might be exacted notwithstanding the fact that the dispensaries were acting for and on behalf of the State and derived no profit therefrom. Justice Brewer, who wrote that decision, was careful to point out therein, p. 458—

"* * * that the tax is not imposed on any property belonging to the State, but is a charge on a business before any profits are realized therefrom."

The commissioner also relies upon the decision of the Supreme Court in Salt Lake City v. Hollister, 118 U. S. 256, but in that case the constitutional power of the Federal Government to tax a city engaged in distilling liquors was not discussed.

That the city will apply the revenue derived from its proportion of the oil produced from its land to municipal purposes must be assumed as it has no authority to apply such funds to any other purpose; that the amount of this fund will be diminished to some extent by the requirement that the lessee pay a tax upon its income derived from the sale of its proportion of the oil is as clear in the case at bar as in those cases wherein the right of the Federal or State Government to tax proceeds from publicly owned
189 oil lands has been denied. We therefore conclude that the attempt to impose a tax upon the income of the petitioner as lessee of the lands of the city of Long Beach is unauthorized and that the order of the Board of Tax Appeals must be reversed and the determination of the tax commissioner fixing a deficiency tax set aside.

(Endorsed:) Opinion. Filed September 8, 1932. Paul P. O'Brien, clerk.

190 *Judgment*

United States Circuit Court of Appeals for the Ninth Circuit

A. T. Jergins Trust, petitioner, vs. Commissioner of Int. Revenue, respondent, and Commissioner of Int. Revenue, petitioner, vs. A. T. Jergins Trust, respondent. No. 6768.

Upon petitions to review an order of the United States Board of Tax Appeals, this cause came on to be heard on the transcript of the record from the United States Board of Tax Appeals and was duly submitted.

On consideration whereof, it is now here ordered and adjudged by this court, that the order of the said Board of Tax Appeals in this cause be, and hereby is, reversed, and the determination of the tax commissioner fixing a deficiency tax set aside.

(Indorsed:) Judgment. Filed and entered September 8, 1932. Paul P. O'Brien, clerk.

191 [Omitted.]

192 In the United States Circuit Court of Appeals for the Ninth Circuit

A. T. Jergins Trust, petitioner, vs. Commissioner of Internal Revenue, respondent. CCA–No. 6768

Motion

Comes now the Commissioner of Internal Revenue, the respondent in the above-entitled cause, by his attorney, C. M. Charest, general counsel for the Bureau of Internal Revenue, and moves the court to enter an order staying its mandate for a period of three months from the date of the entry of the judgment herein.

In support of this motion the said Commissioner of Internal Revenue respectfully shows to the court that he is considering the advisability of filing in the Supreme Court, within the three months' period provided by statute in that respect, a petition for certiorari in this cause and that he believes it undesirable under such circumstances to have the mandate issue in accordance with the general rules of this court.

C. M. CHAREST,
General Counsel, Bureau of Internal Revenue.

193 United States Circuit Court of Appeals for the Ninth Circuit

A. T. Jergins Trust, petitioner, vs. Commissioner of Internal Revenue, respondent; and Commissioner of Internal Revenue, petitioner, vs. A. T. Jergins Trust, respondent. No. 6768

Order staying issuance of mandate

Upon application of Mr. C. M. Charest, general counsel, Bureau of Internal Revenue, counsel for the respondent and petitioner commissioner, and good cause therefor appearing, *it is ordered* that the issuance, under rule 32, of the mandate of this court in the above cause be, and hereby is, stayed to and including December 8, 1932; and in the event the petition for a writ of certiorari to be made by the respondent herein be docketed in the clerk's office of the Supreme Court of the United States on or before said date, then the mandate of this court is to be stayed until after the said Supreme Court passes upon the said petition.

WM. H. SAWTELLE,
United States Circuit Judge.

Dated: San Francisco, California, September 26, 1932.

(Indorsed:) Motion for and order staying issuance of mandate. Filed Sept. 26, 1932. Paul P. O'Brien, clerk.

A. T. Jergins Trust vs. Commissioner of Internal Revenue, and Commissioner of Internal Revenue vs. A. T. Jergins Trust. No. 6768

Certificate of clerk U. S. Circuit Court of Appeals for the Ninth Circuit to record certified under rule 38 of the revised rules of the Supreme Court of the United States

I, Paul P. O'Brien, as clerk of the United States Circuit Court of Appeals for the Ninth Circuit, do hereby certify the foregoing one hundred ninety-three (193) pages, numbered from and including 1 to and including 193, to be a full, true, and correct copy of the entire record of the above-entitled case in the said Circuit Court of Appeals, made pursuant to request of Hon. Thomas D. Thacher, Solicitor General, counsel for the commissioner, and certified under rule 38 of the revised rules of the Supreme Court of the United States, as the originals thereof remain on file and appear of record in my office.

Attest my hand and the seal of the said the United States Circuit Court of Appeals for the Ninth Circuit, at the city of San Francisco, in the State of California, this 24th day of October, A. D. 1932.

[SEAL.] PAUL P. O'BRIEN, *Clerk.*

U. S. GOVERNMENT PRINTING OFFICE: 1932

Supreme Court of the United States

Order allowing certiorari

Filed January 16, 1933

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

○

FILED
DEC 8 1932
CHARLES ELMORE CROPLEY
CLERK

FILE COPY

No. 541

In the Supreme Court of the United States

OCTOBER TERM, 1932

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

A. T. JERGINS TRUST

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1932

No. ——

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

A. T. JERGINS TRUST

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Ninth Circuit, entered in this case on September 8, 1932.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 96–124) is reported in 22 B. T. A. 551. The opinion of the Circuit Court of Appeals (R. 183) has not yet been reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered September 8, 1932. (R. 191.) Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. May the United States impose a tax upon income of a private association derived from the sale of oil and gas produced under an oil and gas lease of land owned by the city of Long Beach, California, the land having been acquired by the city, together with other lands, for the purpose of furnishing water to its inhabitants, and having been temporarily leased to the taxpayer, subject to termination on short notice and subject to the right of the city to use the property for water purposes?

2. In determining net income under the Revenue Act of 1921, may capitalized expenses for drilling and developing oil wells be deducted from gross income as depletion allowance?

STATUTES INVOLVED

These are set forth in the Appendix, *infra*, p. 8.

STATEMENT

The findings of fact made by the Board of Tax Appeals (R. 98–115) may be summarized as follows:

The taxpayer, an association organized in 1922 under the laws of California, was created for the purpose of entering into an oil and gas lease with the city of Long Beach, California, a municipal corporation. That city was authorized by its charter to own a water system and to purchase, hold, lease, and enjoy property of every kind and to control and to dispose of the same for the common good. (R. 98.)

Prior to 1911 the city obtained its water supply from two or more independent water companies. (R. 98.) The service being unsatisfactory and inadequate, the city acquired the equipment and mains of these companies, including 600 acres of land. Portions of this land not immediately required in connection with its municipal water plant were used by two oil and gas lessees (one of which is the respondent), and by about 60 tenants holding under leases or permits from the city. (R. 99.)

The business of these tenants included airplane repair, hangars for aircraft, oil-well supplies, telephone, storage plants, cracking plants, oil-skimming plants, dehydration plants, gasoline absorption plants, and farming. The leases were of a temporary nature, could be terminated on short notice, and were made subject to the right of the city to use the property for water purposes.

In 1922 the city, as lessor, and the respondent, as lessee, entered into an oil lease on about 140 acres of the 600-acre tract. (R. 100.) By the terms of

this lease the city was to receive forty per centum of the oil and gas produced, payable in kind or in money. (R. 107.) There was no finding by the Board of Tax Appeals as to the use made by the city of the receipts under this lease.

In 1922 all of respondent's gross income was derived from oil and gas produced under the lease. In 1923 $985,790.34 was so derived, and in 1924 $1,935,376.82. (R. 109–110.) The Board of Tax Appeals held that the United States could tax that income, and sustained the Commissioner's determination to that extent. (R. 118.)

There was also submitted to the Board the question whether certain capitalized sums expended by the respondent for drilling costs and development expense in connection with oil wells were returnable to respondent through a depletion or a depreciation allowance. (R. 113–115.) The Commissioner had treated such sums as subject only to a depletion allowance, but the Board held that they were subject to depreciation allowance.[2] (R. 120–123.)

[2] The Board's decision on this question is in accord with the decision of the Court of Claims in *Dakota-Montana Oil Co.* v. *United States*, 59 F. (2d) 853, in which the United States has filed a petition for certiorari, No. 434, October Term, 1932. The Board's decision is contrary to the decision in *Burnet* v. *Petroleum Exploration* (C. C. A. 4th), decided October 3, 1932, in which the taxpayers filed a petition for certiorari, No. 448, October Term, 1932. The petitions in those cases were granted November 14, 1932, and thus the precise question is already before this Court.

The respondent appealed from the portion of the Board's decision holding that its income derived from the oil lease on city lands was taxable, and the Commissioner appealed from the portion of the Board's decision allowing deduction of capitalized costs as depreciation. The Circuit Court of Appeals for the Ninth Circuit held that the tax assessed by the Commissioner could not constitutionally be imposed upon the income derived by the respondent from the sale of oil taken from the land leased by the city, and concluded that the assessment of the Commissioner should be set aside. Accordingly, the court did not pass upon the question presented by the Commissioner's appeal.

SPECIFICATIONS OF ERROR

The Circuit Court of Appeals erred:

1. In holding that the respondent's income derived from the sale of respondent's share of oil and gas produced under a lease of land owned by the city of Long Beach, California, could not be taxed by the United States.

2. In reversing the decision of the Board of Tax Appeals holding that such income was subject to Federal taxation.

3. In failing to hold that respondent's capitalized expenses for drilling oil wells were recoverable only through a depletion allowance.

4. In failing to hold that respondent's capitalized expenses for development of oil wells were recoverable only through a depletion allowance.

5. In reversing the determination of the Commissioner of Internal Revenue assessing a deficiency.

REASONS FOR GRANTING THE WRIT

1. The decision of the court below involves a radical extension of the immunity of State instrumentalities from Federal taxation. Such immunity is extended in this case to the lessee of oil lands owned by a municipality which were not devoted to a governmental purpose, without proof that the royalties payable to the city under the provisions of the lease were to be devoted to any governmental purpose. The court below, quite erroneously we believe, considered the decisions of this Court in *Burnet* v. *Coronado Oil & Gas Company,* 285 U. S. 393, and *Gillespie* v. *Oklahoma,* 257 U. S. 501, as controlling. The extension of sovereign immunity from taxation to the income derived by private lessees from property leased by a municipal corporation, used by the lessees for private business purposes, may seriously impair the revenues of the Federal Government. We accordingly believe that the question presented is one of sufficient general importance to require review.

2. In reversing the determination of the Commissioner of Internal Revenue assessing a deficiency, the court below failed to correct the erroneous decision of the Board of Tax Appeals that certain capitalized expenses of the respondent for drilling and development of certain oil wells were

recoverable through depreciation. Under the applicable Revenue Acts and the regulations thereunder such expenses were recoverable only through depletion. This question is presented in *United States* v. *Dakota-Montana Oil Co.*, No. 434, October Term, 1932, now pending on writ of certiorari granted November 14, 1932, and *Petroleum Exploration* v. *Burnet*, No. 448, October Term, 1932, now pending on writ of certiorari granted November 14, 1932; and therefore the question should also be considered in this case.

Wherefore it is respectfully submitted that the petition should be granted.

THOMAS D. THACHER,
Solicitor General.

DECEMBER, 1932.

APPENDIX

Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 254:

> SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—
>
> (a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
>
> SEC. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in sections 213 and 217, except that mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance.
>
> * * * * *

Sections 213 and 233 of the Revenue Act of 1924, c. 234, 43 Stat. 253, 267, 283 (U. S. C., Title 26, Secs. 954 and 985) contain provisions substantially the same as those of the corresponding sections of the 1921 Act above quoted.

U. S. GOVERNMENT PRINTING OFFICE: 1932

FILE COPY

No. 541

In the Supreme Court of the United States

OCTOBER TERM, 1932

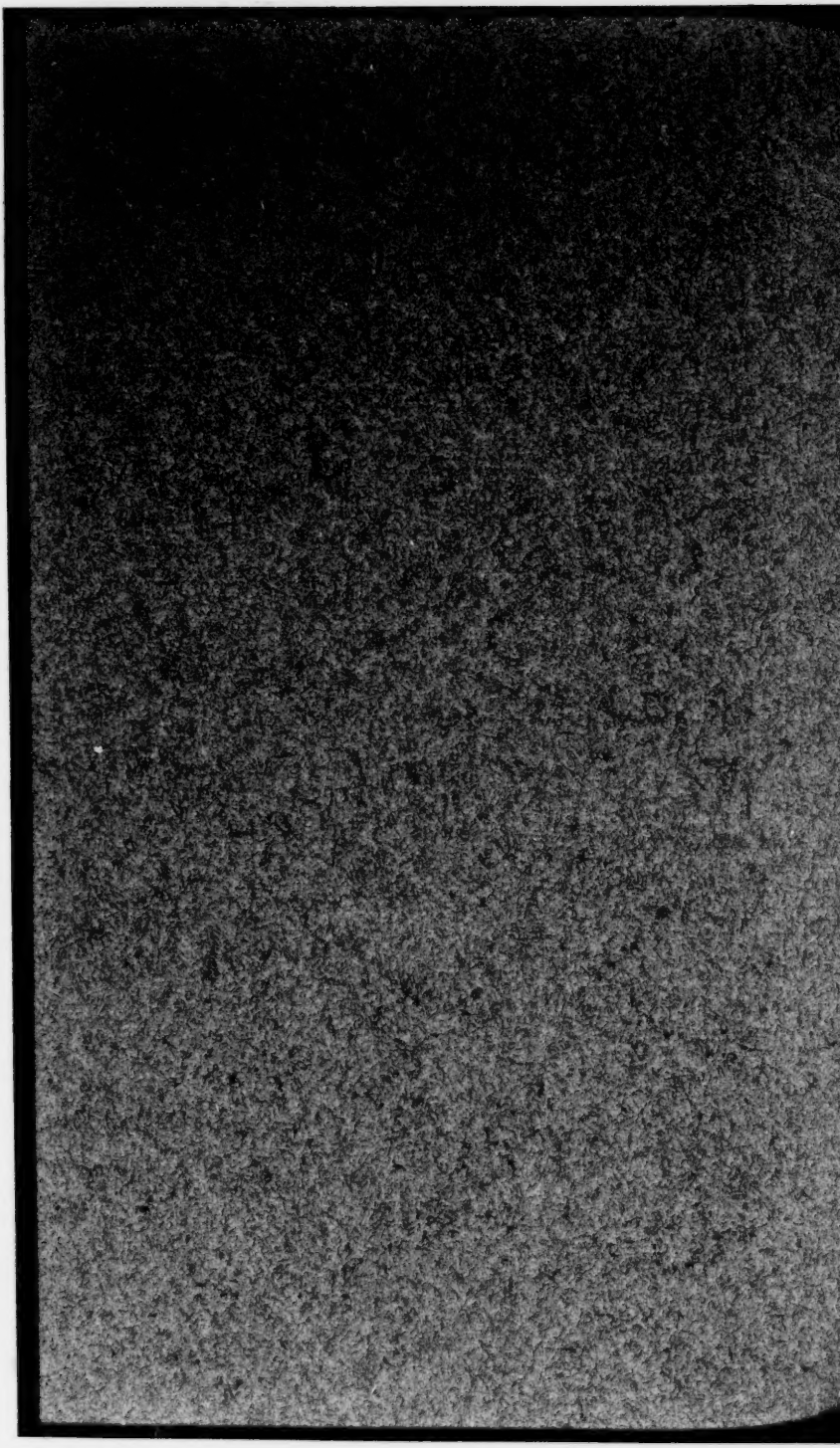
DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

A. T. JERGINS TRUST

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER



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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 115–124) is reported in 22 B. T. A. 551. The opinion of the Circuit Court of Appeals for the Ninth Circuit (R. 182–187) is reported in 61 F. (2d) 92.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered September 8, 1932. (R. 187.) The petition for a writ of certiorari was filed December 8, 1932, and was granted January 16, 1933. (R.

190.) Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. May the United States tax income of a private association derived from the sale of oil and gas produced under an oil and gas lease of land owned by the City of Long Beach, California, the land having been acquired originally by the city, together with other lands, for the purpose of furnishing water to its inhabitants?

2. In determining net income under the Revenue Act of 1921, may capitalized expenses for drilling and developing oil wells be deducted from the gross income as depreciation allowance?

STATUTES AND REGULATIONS INVOLVED

These are set forth in the Appendix, *infra*, pp. 21–24.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 98–115) may be summarized as follows:

1. *As to the lease:*

The taxpayer is an association which was organized in April, 1922, under a declaration of trust executed pursuant to the laws of California. It was created for the purpose of entering into an oil and gas lease with the City of Long Beach, California, a municipal corporation. (R. 98.)

The charter of the City authorized it to acquire and own its water system and to purchase, hold,

lease, use, and enjoy property of every kind and description and to control and dispose of the same for the common good. (R. 98.)

Prior to 1911 the City had obtained its water supply from two or more independent water companies. The mains of these companies were maintained in an unsanitary fashion and could not resist sufficient pressure to enable the fire department to fight fires. (R. 98–99.) Under these conditions the City acquired from the water companies 600 acres of land and their equipment and mains. The land has since been used by the City for the purpose of a water plant and for other purposes. It was occupied in part by about 60 tenants (in addition to the tenants under the oil and gas leases) holding under leases or permits from the City. The businesses of these tenants include airplane repair, hangars for aircraft, oilwell supplies, telephone, storage plants, cracking plants, oil-skimming plants, dehydration plants, gasoline absorption plants, and farming. Such leases and permits were of a temporary nature and could be terminated on short notice, and were made subject to the right of the City to use the property for water purposes. (R. 99–100.)

In connection with the water system the City employed in 1922, 1923 and 1924 about fifty men, whose headquarters were on the 600 acres. (R. 99.)

In 1922 the City made an oil lease to the respondent of about 140 acres of the water system property.

(R. 100.) The lease provided, among other things, that no drilling should be done in certain areas without consent of the city manager (R. 101.); that the lessor reserved the right to use the land for agricultural, grazing, and such other purposes as it might deem necessary, in so far as such use would not interfere with any of the rights or necessary operations of the respondent (R. 102); that respondent would protect all the works of the lessor and any stored water on the lands against damage (R. 102–103); that all taxes imposed by the State of California or the United States, or any subdivisions of either, upon the lands should be paid in proportions of 40% by the lessor and 60% by the respondent (R. 44, 56, 106).[1]

In connection with the operation of the lease the City employed an oil engineer, whose duty it was to see that the respondent performed its contractual duties and that the City got its share of the oil and gas. The oil was sold under a joint contract between the City and respondent, as provided in the lease. The City kept a man on the leased property to keep the Superintendent of the Water Department informed of the respondent's activities. Conferences between city authorities and the respondent were generally held whenever a new well was to be located. The purpose of these prac-

[1] The full text of the lease was annexed to the petition to the Board of Tax Appeals. (R. 33–58.) The pertinent parts are quoted in the findings of fact made by the Board. (R. 100–108.)

tices was that the City might secure the maximum amount which could be obtained from its share of the oil and gas. (R. 109.)

All of the taxpayer's gross income for 1922 was derived from oil and gas produced under the lease. In 1923 and 1924 the amounts of $985,790.34 and $1,935,376.82, respectively, were derived from the same source. (R. 109–110.)

2. *As to deductions for depreciation:*

During 1922 the respondent expended $59,376.86 for physical equipment and $102,508.85 for wages, fuel, repairs, hauling, etc., in connection with development and drilling. (R. 113.) The full amount of these expenses, $161,885.81, was capitalized in the determination of the deficiency for the year 1922. (R. 114.)

During the year 1923 respondent expended $260,313.62 for physical equipment and $431,393.11 for wages, fuel, repairs, hauling, etc., in connection with development and drilling. The full amount, $691,606.73, was capitalized in the determination of the deficiency for the year 1923. (R. 114.)

During the year 1924 the respondent expended $303,244.69 for physical equipment and $452,226.75 for fuel, repairs, hauling, etc., in connection with development and drilling. The full amount, $755,-471.44, was capitalized in the determination of the deficiency for 1924. (R. 114.)

The petitioner allowed depreciation only on the amounts expended for physical equipment, and

added the drilling expenses to sums recoverable through depletion. (R. 114.) He computed respondent's depletion allowance for 1924 based upon cost of leaseholds and development cost, plus discovery value, at the amount of $1,228,864.99, and allowed a deduction of $771,982.99. (R. 114–115.)

The petitioner determined deficiencies in income tax for the years 1922, 1923, and 1924 in the respective amounts of $1,126.62, $3,368.92, and $61,458.34. (R. 97.)

The Board of Tax Appeals held (1) that the respondent's income derived from the lease was not exempt from Federal income and profits taxation (R. 118), and (2) that expenditures for fuel, wages, repairs, hauling, etc., in connection with the drilling of oil and gas wells were capital expenses, recoverable through depreciation rather than depletion (R. 123).

The respondent appealed from the Board's decision that it could be taxed for earnings derived under the lease. (R. 145.) The petitioner appealed from the Board's decision permitting a depreciation allowance as to capitalized expenses for drilling costs and development which he had treated as returnable only through a depletion allowance. (R. 153.)

The Circuit Court of Appeals for the Ninth Circuit held that the respondent was an instrumentality of the City and could not be taxed by the United

States (R. 187), and thus found it unnecessary to decide the question of allowance of drilling and development expense.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the respondent's income derived from the sale of respondent's share of oil and gas ~~purchased~~ produced under a lease of land owned by the City of Long Beach, California, may not be taxed by the United States.

2. In reversing the decision of the Board of Tax Appeals holding that such income is subject to Federal taxation.

3. In failing to hold that respondent's capitalized expenses for drilling and development were recoverable only through a depletion allowance.

4. In reversing the determination of the Commissioner of Internal Revenue assessing a deficiency.

SUMMARY OF ARGUMENT

Decision in this case is not controlled by *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393, and *Gillespie* v. *Oklahoma*, 257 U. S. 501. The tax upon the income of the respondent, a private trust which had leased lands from the City of Long Beach, California, does not affect directly or indirectly the performance by the City of any governmental function.

Taxation of the respondent's income does not directly interfere with the performance of any

governmental function. The action of the City in leasing its oil lands and deriving royalties therefrom was proprietary and nongovernmental. The lands involved were not needed for any governmental purpose and the lease had no relation to the performance of any governmental purpose. Even if the leased lands were held for future use in connection with the City's water supply, the supplying of water to the inhabitants of a city is not a governmental function.

Immunity of the respondent is not required because a Federal tax upon it would have any substantial indirect effect upon the performance of governmental functions. There is no showing that the income received by the City under the lease was devoted to any such function, and no presumption can be indulged that it was so devoted. Since the taxpayer is seeking immunity, it has the usual burden of establishing the facts upon which immunity must rest. It has failed to sustain the burden.

II

The decision of the Board of Tax Appeals that capitalized sums expended for drilling and development were returnable to the taxpayer through a depreciation allowance was erroneous, for the reasons set forth in Point I of the Government's brief in *Dakota-Montana Oil Co.* v. *United States*, No. 434. In the event that the judgment of the court

below is reversed, the Court should also reverse the decision of the Board of Tax Appeals upon this phase of the case.

ARGUMENT

I

THE RESPONDENT'S INCOME WAS NOT IMMUNE FROM FEDERAL TAXATION

The court below concluded that it was constrained to hold that the respondent was immune from Federal taxation upon its income derived from oil lands leased to it by the City of Long Beach principally because of the decisions of this Court in *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393, and *Gillespie* v. *Oklahoma*, 257 U. S. 501. In the former this Court held that when Oklahoma, for the benefit of its public schools, leased its public lands, dedicated from the time of their acquisition to support of the public-school system, it exercised a function strictly governmental in character; accordingly, it was decided, no Federal tax could be levied on the income of the State's lessees, since such a tax, it was said, would amount to an imposition on the lease itself, which the Court held was one of the States's instruments of government. In the *Coronado case* this Court adhered to and applied its ruling in the *Gillespie case*, where the income of a lessee of Indian lands was held to be immune from State taxation, but in so doing clearly indicated its purpose to apply the doctrine of the

Gillespie case "strictly and only in circumstances closely analogous to those which it disclosed" (p. 398).

We believe that the court below has extended the rule thus limited and applied in the *Coronado case* to circumstances which bear no analogy to those in either the *Coronado* or the *Gillespie case*. In the instant case none of the factors which induced the Court to follow and apply the rule of the *Gillespie case* in the *Coronado case* are present. No governmental instrumentality was subjected to Federal taxation; no strictly governmental function has been impaired.

It is axiomatic that the implied constitutional prohibition against taxation by the Federal Government of agencies or instrumentalities of a State is limited to protecting the States, their agencies and instrumentalities, in the performance of their strictly governmental functions against substantial interference through taxation by the Federal Government. It is settled that a tax offends against that limitation only if it is imposed directly upon a governmental instrumentality of the State, or if, though not so imposed, its effect is to place a substantial burden upon the exercise of a governmental function. *Willcuts* v. *Bunn*, 282 U. S. 216; *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 525.[2]

[2] This proposition is sustained by numerous other decisions of this Court, including *Fox Film Corp.* v. *Doyal*, 286 U. S. 123, 128; *Group No. 1 Oil Corp.* v. *Bass*, 283 U. S. 279, 282; *Alward* v. *Johnson*, 282 U. S. 509; *Educational*

As this Court said in *Indian Motocycle Co.* v. *United States,* 283 U. S. 570, 576, "* * * the immunity does not extend to anything lying outside or beyond governmental functions and their exertion * * *"; hence one claiming immunity must establish that the burden of the tax imposed upon him is a substantial burden upon the exercise of some governmental function. The immunity does not reach a nondiscriminatory tax on transactions that are merely related to governmental instrumentalities or functions. *Willcuts* v. *Bunn, supra,* pp. 227, 229.

A

The tax declared by the court below to have been illegally assessed was an income tax assessed upon the income of a lessee of lands theretofore acquired by a municipality in connection with the acquisition of the properties of two or more independent water companies whose service in furnishing water to the inhabitants of the City had not been satisfactory. Much of the property thus acquired was

Films Corp. v. *Ward*, 282 U. S. 379; *Shaw* v. *Oil Corp.*, 276 U. S. 575; *New Brunswick* v. *United States*, 276 U. S. 547; *Choctaw O. & G. R. R. Co.* v. *Mackey*, 256 U. S. 531; *Ackerlind* v. *United States*, 240 U. S. 531, 536; *Gromer* v. *Standard Dredging Co.*, 224 U. S. 362; *Elder* v. *Wood*, 208 U. S. 226; *Baltimore Shipbuilding Co.* v. *Baltimore*, 195 U. S. 375; *Wagoner* v. *Evans*, 170 U. S. 588; *Thomas* v. *Gay*, 169 U. S. 264; *Central Pacific R. R.* v. *California*, 162 U. S. 91; *Salt Lake City* v. *Hollister*, 118 U. S. 256; *Forbes* v. *Gracey*, 94 U. S. 762; *Railroad Co.* v. *Peniston*, 18 Wall. 5; *Thomson* v. *Pacific Railroad*, 9 Wall. 579; *Veazie Bank* v. *Fenno*, 8 Wall. 533, 547; *Philadelphia* v. *The Collector*, 5 Wall. 720.

not presently required in connection with the business of water supply which the City took over from these public service corporations. It was therefore available, as property owned by the City but not presently needed, for such nongovernmental uses as might be most profitable, and leases to various tenants were made for various strictly private uses. The situation is the reverse of that presented in *Trinidad* v. *Sagrada Orden,* 263 U. S. 578, 582, in that the City instead of adhering to and advancing the purpose for which the lands were originally acquired, stepped aside from that purpose and devoted them to general business pursuits. Under these circumstances the mere fact that the lessor was a municipality does not render the tenant immune from taxation, for it is a matter of common knowledge that municipalities exercise functions which are purely proprietary as well as those which are strictly governmental. See *Vilas* v. *Manila,* 220 U. S. 345, 356. It will not suffice for the lessee, seeking exemption for itself from the payment of income taxes, to show that its income has been derived from lands leased from a municipal corporation. In order to prove the exemption it must also be shown that imposition of the tax upon the lessee's income will result in substantial interference with the performance by the City of some strictly governmental function. The record does not disclose the use to which the royalties paid the City were put; but assuming, in the absence of any show-

ing on the record, that they were devoted to governmental purposes, such use would not be sufficient basis for exemption of such receipts (*South Carolina* v. *United States,* 199 U. S. 437; *Olson* v. *North Dakota,* 33 F. (2d) 848 (C. C. A. 8th), appeal dismissed for lack of jurisdiction, 280 U. S. 528), and much less of the profits of the lessee.

Standing alone, a lease of lands for the extraction of oil is a purely private enterprise unrelated to any governmental function, and the mere fact that the municipality derives profit from the transaction does not exempt the lessee's profit from Federal taxation. See *South Carolina* v. *United States,* 199 U. S. 437. The situation at bar is not different from a case where a city leases vacant land to one who erects an office building thereon, or to a farmer for agricultural purposes. Certainly the income of the lessee would not be exempt from tax. In such cases the City is a mere proprietor engaged in business for profit and the individual dealing with the City under such circumstances should not be entitled to draw about him the cloak of immunity which was designed solely to protect the States and their agencies in the exercise of their governmental functions.

The mere fact that the City originally acquired the lands in connection with other lands acquired for water purposes does not require a different conclusion. The oil lease to the respondent had nothing to do with the supply of water. The land was,

in effect, segregated from the balance of the tract and devoted to other and wholly different purposes. Thus, even if, contrary to the fact, supplying water could be regarded as a governmental function, the tax upon the lessee of lands not then used for that purpose would have no connection with its performance. We submit that there is no principle by which a city, having provided itself with land not presently useful for strictly governmental purposes, can lease such land to private individuals or companies for an entirely different purpose and thus confer tax immunity of the kind now claimed.[3]

Even if it should be considered that the leasing of a portion of the tract originally acquired for the purpose of supplying water did not constitute a temporary abandonment of that use as far as these lands are concerned, it is clear that the present tax has no economic effect upon the performance of

[3] The record in the instant case illustrates the absurd consequences which might be produced if respondent's position were sustained. The land originally acquired by the City as a source of its water supply was in part leased to 60 tenants. (R. 99.) Although by provision for cancellation on short notice the City reserved the right to resume possession (R. 100), until cancelled there was no connection between the business of supplying water and the making of leases to such tenants. If the judgment of the court below is affirmed, it would seem to follow that these tenants of the City, who were engaged in such diverse businesses as oil-well supplies, dehydration plants, airplane repair, and farming, were governmental instrumentalities of the City, and that their income was immune from Federal taxation.

any governmental function of the City of Long Beach, for the supplying of water, while undoubtedly a "public" or "municipal" purpose, is not a strictly governmental function. Decisions of the California courts clearly indicate that the business of supplying water is not regarded as a governmental function. See *Davoust* v. *City of Alameda*, 149 Cal. 69, 72–73; *South Pasadena* v. *Pasadena Land, etc., Co.*, 152 Cal. 579, 593; *Morrison* v. *Smith Bros., Inc.*, 211 Cal. 36, 45; *Chafor* v. *City of Long Beach*, 174 Cal. 478, 483; *Marin Water, etc. Co.* v. *Town of Sausalito*, 168 Cal. 587, 594–595; *Sincerney* v. *City of Los Angeles*, 53 Cal. App. 440, 447.[1]

[1] The view of the California courts is supported by the weight of authority elsewhere. See *Blair* v. *Byers*, 35 F. (2d) 326 (C. C. A. 8th); *Winona* v. *Botzet*, 169 Fed. 321 (C. C. A. 8th); *Omaha Water Co.* v. *Omaha*, 147 Fed. 1 (C. C. A. 8th); *Canaran* v. *Mechanicsville*, 229 N. Y. 473, 476; *Wiltse* v. *Red Wing*, 99 Minn. 255, 260; *Lynch* v. *Springfield*, 174 Mass. 430; *Public Service Comm.* v. *Helena*, 52 Mont. 527; *Miller Grocery Co.* v. *Des Moines*, 195 Iowa 1310; *Pacific Paper Co.* v. *Portland*, 68 Ore. 120.

It is immaterial that part of the water distributed was used for fire protection, since there is no proof that the land here involved was used in connection with the storage or supply of water for that purpose. Nor is there any proof that the tax here imposed would in any way burden the City in providing fire protection for its inhabitants. Moreover, the proprietary aspect of the operation of the water system of a municipality is not affected by the circumstance that one of the uses of the system may be in connection with fire protection. *Miller Grocery Co.* v. *Des Moines*, *supra*, p. 1315; *Piper* v. *Madison*, 140 Wis. 311; *Blake-McFall Co.* v. *Portland*, 68 Ore. 126; *Aschoff* v. *Evansville*, 34 Ind. App. 25.

This Court in *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, said (p. 172):

> It is no part of the essential governmental functions of a State to provide means of transportation, supply artificial light, water, and the like. * * *
>
> The true distinction is between the attempted taxation of those operations of the States essential to the execution of its governmental functions, and which the State can only do itself, and those activities which are of private nature.

See also *South Carolina* v. *United States*, *supra*, p. 462.

It is plain, therefore, that whether the leasing of lands to respondent be deemed a venture for profit unconnected with its proprietary business of supplying water or as a part of that business, still it was not connected with the performance by the City of any governmental function. Hence no direct interference with the performance of a function of government is involved, and, unless there is a showing of some indirect effect which interferes substantially with the performance of such functions, the tax must be upheld.

B

In *Burnet* v. *Coronado Oil & Gas Co.*, *supra*, the Court applied *Gillespie* v. *Oklahoma*, *supra*, to what it regarded as an analogous situation. In the *Coronado case* there was the combination of circumstances that the land leased had been dedicated

by the grant from the United States and the organic law of Oklahoma to the furtherance of a governmental function and that the proceeds of the leases were required to be paid into the school fund. The lands in the *Gillespie case* were held in trust for the Indians by the United States. The court therefore concluded that the leases were governmental instrumentalities. In the case at bar the City was free to devote its profits from the lease to any purpose, whether proprietary or governmental. So far as appears from the record, the functions of the City were not in any way affected by the tax on respondent's income.

The court below assumed that the City's income would be used for "municipal purposes" (R. 187) and it apparently considered that such use was sufficiently synonymous with use for strictly governmental purposes. We submit, however, that common knowledge of the many nongovernmental uses to which municipal funds are put, as well as the facts readily available as to the fiscal activities of the City of Long Beach, forbid resort to a presumption that the funds were devoted to purposes *strictly governmental*. The City of Long Beach has built and maintained an auditorium and meeting hall, a venture which the Supreme Court of California has held to have been undertaken in its proprietary, as distinguished from its governmental, capacity. *Chafor* v. *Long Beach*, 174 Cal. 478. The report of its auditor for the City's fiscal

years which embrace the taxable periods involved in this case show substantial expenditures for such municipal, but certainly nongovernmental, purposes as advertising, donations to charitable institutions, piers, waterworks, municipal market, wharves and docks, and support of a municipal band. See *Auditor's Annual Report, City of Long Beach, California, Fiscal Years Ending June 30, 1922, 1923, 1924.* Assuming for the purpose of argument, but not conceding, that devoting the proceeds of the lease to strictly governmental functions would support the exemption claimed in this case, a presumption that the funds were so used can not be indulged. It follows that in the absence of proof it was error to conclude that the tax upon the respondent's income imposed an indirect burden on strictly governmental functions, when, with equal assurance upon the basis of facts within common knowledge, it may be said that the City's income was devoted to nongovernmental activities.

The exemption of an instrumentality of one government from taxation by the other must be given a practical application, without an undue impairment either of the taxing power of the one or of the appropriate exercise of its functions by the other. *Susquehanna Co.* v. *Tax Commission (No. 1)*, 283 U. S. 291, 294; *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 523, 524. Respondent has failed to show that any governmental function of the City of Long Beach has suffered or will suffer interference by reason of the Federal tax. This Court has indi-

cated that in this field of taxation, as in all others, one who seeks to escape the burden of a tax must show the facts which entitle him to relief. See *Willcuts* v. *Bunn, supra,* pp. 230, 231; see also *Phillips* v. *Dime Trust & Savings Bank,* 284 U. S. 160, 167; *Burnet* v. *Houston,* 283 U. S. 223, 227; *Niles Bement Pond Co.* v. *United States,* 281 U. S. 357, 361; *Reinecke* v. *Spalding,* 280 U. S. 227, 232.

II

THE DECISION OF THE BOARD OF TAX APPEALS AS TO DEPLETION WAS ERRONEOUS

There was also submitted to the Board of Tax Appeals the question whether the capitalized sums for drilling costs and development expense in connection with oil wells were returnable to respondent through a depletion or a depreciation allowance. (R. 113–115.) The petitioner had treated such sums as subject only to a depletion allowance, as provided in Sections 234 (a) (8) and 204 (c) (3) of the Revenue Act of 1924, as construed by Articles 223 and 225 of Treasury Regulations 62 and 65, *infra,* pp. 22–24. The Board held that they were subject only to depreciation allowance. (R. 120–123.) As the court below held that all of the respondent's income from oil wells was immune from tax, it found it unnecessary to consider or decide this question.

The precise question under the identical provisions of the Revenue Act of 1926 and Regulations thereunder is now before this Court in *United States* v. *Dakota-Montana Oil Co.,* No. 434, October

Term, 1932, and *Petroleum Exploration* v. *Burnet*, No. 448, October Term, 1932, which will be argued before this case. Our contentions on this question are fully set forth in Point I of our brief in No. 434, which, without burdening the Court with a repetition thereof, we adopt as our argument here. For reasons there stated we believe that the decision of the Board herein was erroneous on this point, and that, if this Court reverses the court below, it should also reverse that portion of the decision of the Board of Tax Appeals.

CONCLUSION

The decision of the Circuit Court of Appeals was erroneous, and its judgment should therefore be reversed.

If the judgment of the court below is reversed, the decision of the Board of Tax Appeals that the expenditures of respondent in drilling and developing are subject to a depreciation allowance, instead of a depletion allowance, should also be reversed.

Respectfully submitted.

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FEBRUARY, 1933.

APPENDIX

Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 254:

SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *.

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

* * * * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: * * *; such rea-

sonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *.

Revenue Act of 1924, c. 234, 43 Stat. 253, 267, 283:

[SEC. 213 (U. S. C., Title 26, Sec. 954) is substantially the same as Section 213 of the Revenue Act of 1921 above quoted.]

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(7) A reasonable allowance for the exhaustion, wear, and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

* * * * *

(U. S. C., Title 26. Sec. 986.)

Treasury Regulations 62 (promulgated under the Revenue Act of 1921):

ART. 223. *Charges to capital and to expense in the case of oil and gas wells.*—Such

incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to the capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. An election once made under this option will control the taxpayer's returns for all subsequent years. * * *.

ART. 225. *Depreciation of improvements in the case of oil and gas wells.*—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost (or fair market value as of March 1, 1913, if acquired prior to that date), equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown

to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation may for such property be based upon the length of life of the deposit. * * *.

Treasury Regulations 65 (promulgated under the Revenue Act of 1924):

[Article 225 is the same as Article 223 above, and Article 227 is like Article 225 above.]

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IN THE

SUPREME COURT

OF THE

UNITED STATES.

OCTOBER TERM, 1932.

No. 541

David Burnet, Commissioner of Internal Revenue,
Petitioner,

vs.

A. T. Jergins Trust,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

BRIEF FOR RESPONDENT.

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IN THE

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

BRIEF FOR RESPONDENT.

Opinions Below.

The opinion of the Board of Tax Appeals [R. 96-124], reported in 22 B. T. A. 551, was predicated largely upon its own decision in the case of *Coronado Oil & Gas Co. v. Commissioner* (14 B. T. A. 1214), subsequently reversed by the Supreme Court in *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393, 76 L. Ed. 815. The opinion of the Circuit Court of Appeals [R. 183] in the case at bar has not yet been reported.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered September 8, 1932. [R. 191.] The petition for writ of *certiorari* was filed December 8, 1932. The jurisdiction of this Court is invoked under section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

1. Whether, under the Federal Constitution and the Constitution of the state of California, the income derived by Taxpayer from the development and operation of land belonging to the city of Long Beach pursuant to a lease for a definite period is immune from Federal taxation?

2. Are expenditures for wages, fuel, repairs, hauling, *et cetera*, in connection with development and drilling of oil wells, capital expenditures subject to depreciation?

Question No. 2 becomes academic if Question No. 1 is answered in Taxpayer's favor.

Statutes and Constitutions Involved.

These are set forth in the appendix, *infra*, p. 25.

STATEMENT.

The Findings of Fact made by the United States Board of Tax appeals [R. 98-115] established, among others, the following facts:

For some years prior to 1911 the city of Long Beach had obtained its water supply from independent water companies which in turn obtained their water from sub-

terranean sources through artesian wells on land located approximately three miles north of the city of Long Beach. The water mains of these companies were made of such material that water escaped therefrom and caused mud holes in the streets. When it was necessary to shut the water off from the mains outside water would seep back into them and contaminate the water which thereafter came through them for the use of the city and its citizens. [R. 98.] The escaping water became stagnant and created unsanitary conditions. The mains could not resist sufficient pressure to enable the fire department to fight fires. To correct these conditions the city, in 1911, by public vote, authorized a bond issue for the purpose of acquiring these water lands and water systems. With the money thus obtained the city, in 1911, acquired about 600 acres of this land which has ever since been used by the city as a source of water supply. [R. 99.]

The Respondent (hereinafter referred to as the Taxpayer) was created in April, 1922, by virtue of a declaration of trust executed under and pursuant to the laws of the state of California, for the purpose of entering into an oil and gas lease with the city of Long Beach. On April 11, 1922, oil having been discovered in the vicinity of Long Beach, the city of Long Beach, as lessor, and Taxpayer, as lessee, entered into an oil and gas lease on approximately 140 acres of its water lands. The lease, among other things, provided [R. 100-108]:

(1) That Taxpayer would receive 60% of the proceeds derived from the oil and gas and the city would receive the balance or 40%;

(2) That Taxpayer was to pay all taxes on properties placed by it on the premises and 60% of all taxes levied by the State or Federal Government.

(3) That no structure should be erected within 150 feet of any reservoir;

(4) That no work should be done on west half farm lot 59 without the consent of the City Manager;

(5) That the lessee should operate so as to interfere as little as possible with reserved uses of lessor;

(6) That the lessee should protect all waterworks of lessor against any and all damage.

For the protection of its rights under the lease, the city during the years in question, maintained on the property a laboratory for the purpose of testing all the oil and gas produced; the city employed an oil engineer whose duty it was to see that Taxpayer performed and did not violate its contractual duties and to see that the city obtained the maximum amount to which it was entitled under the lease. [R. 109.] The oil and gas recovered from said premises have been sold under a joint contract of the city and Taxpayer as provided in the lease. Tests were made of the runs of oil. Conferences between Taxpayer's representatives and the city authorities have been generally held whenever the location of a new well was to be determined.

The city had made one other oil lease on another portion of its land. In addition to the foregoing, the city had issued temporary leases and permits which were subject to termination on short notice to about sixty tenants whose

business included airplane repair, hangars for aircraft, oil-well supplies, telephone, storage plants, cracking plants, oil-skimming plants, dehydration plants, gasoline absorption plants and farming. [R. 100.]

In 1922 all of Taxpayer's gross income was derived from oil and gas produced under the lease. In 1923 $985,790.34 was so derived, and in 1924 $1,935,376.82. [R. 109-110.] The Board of Tax Appeals held that the United States could tax that income, and sustained the Commissioner's determination to that extent. [R. 118.]

There was also submitted to the Board the question whether certain capitalized sums expended by the Taxpayer for drilling costs and development expense in connection with oil wells were returnable to Taxpayer through a depletion or a depreciation allowance. [R. 113-115.] The Commissioner had treated such sums as subject only to a depletion allowance, but the Board held that they were subject to depreciation allowance. [R. 120-123.]

The Taxpayer appealed from the portion of the Board's decision holding that its income derived from the oil lease on city lands was taxable, and the Commissioner appealed from the portion of the Board's decision allowing deduction of capitalized costs as depreciation. The Circuit Court of Appeals for the Ninth Circuit held that the tax proposed by the Commissioner could not constitutionally be imposed upon the income derived by the Taxpayer from the sale of oil taken from the land leased by the city, and concluded that the assessment of the Commissioner should be set aside. Accordingly, the Court did not pass upon the question presented by the Commissioner's appeal as that question then became academic.

Reasons for Not Granting Writ.

The taxpayer has not been served with a brief in support of the Commissioner's petition for writ of *certiorari* and it is assumed that no brief in support thereof will be filed or considered without affording taxpayer an opportunity to make a reply thereto.

The Decision of the Ninth Circuit in This Case Is but the Application of Principles Already Laid Down by the Supreme Court in Numerous Cases.

(A) The Supreme Court Has Repeatedly Held That if the Source From Which Revenue Is Derived Cannot Be Taxed Then the Revenue Itself Cannot Be Taxed.

In the famous case of *Pollock v. Farmers Loan and Trust Company*, 157 U. S. 429, on rehearing, 158 U. S. 601, at page 618, the Supreme Court said:

> "* * * As to the income from municipal bonds, they could not be taxed because of want of power to tax the source, * * *."

Further on at page 630 the Supreme Court made the following comment:

> "* * * and it follows that, if the revenue derived from municipal bonds cannot be taxed because the source cannot be, the same rule applies to revenue from any other source not subject to the tax; * * *."

The same principle is laid down as absolute in the following cases:

Northwestern Mutual Life Insurance Co. v. Wisconsin, 275 U. S. 136;

Gillespie v. State of Oklahoma, 257 U. S. 501.

In the case of *Gillespie v. State of Oklahoma, supra,* the Court spoke as follows:

> "The rule as to instrumentalities of the United States, * * * is absolute in form * * *. 'A tax upon the leases is a tax upon the power to make them, and could be used to destroy the power to make them.' 240 U. S. 530. The step from this to the invalidity of the tax upon income from the leases is not long.
>
> "In cases where the principal is absolutely immune from interference, an inquiry is allowed into the sources from which net income is derived, and if a part of it comes from such a source, the tax is *pro tanto* void."

The mandate of the Supreme Court expressed in the foregoing could not be more definite:

> "The same considerations that invalidate a tax upon the leases invalidate a tax upon the profits of the leases."

In the case of *Northwestern Mutual Life Insurance Company v. Wisconsin, supra,* the Supreme Court said:

> "Certainly, since Gillespie v. Oklahoma, 257 U. S. 501, 505, it has been the settled doctrine here that where the principal is absolutely immune, no valid tax can be laid upon income arising therefrom."

The source of the revenue in this case was the land belonging to the city of Long Beach. Even disregarding for a moment the circumstances under which and purposes for which the land in question was acquired and used by the city, could the Federal Government lawfully and constitutionally impose a tax upon that land?

In the case of *Pollock v. Farmers Loan and Trust Company, supra,* we find the following language which is at once expressive of the reasoning and the decision of the Court in that case:

> "As the States cannot tax the powers, the operations, or the property of the United States, nor the means which they employ to carry their powers into execution, so it has been held that the United States have no power under the Constitution to tax either the instrumentalities or the property of a State.
>
> "A municipal corporation is the representative of the State and one of the instrumentalities of the state government. It was long ago determined that the property and revenues of municipal corporations are not subjects of Federal taxation. Collector v. Day, 11 Wall. 113, 124; United States v. Railroad Company, 17 Wall. 322, 332. In Collector v. Day, it was adjudged that Congress had no power, even by an act taxing all incomes, to levy a tax upon the salaries of judicial officers of a State, for reasons similar to those on which it had been held in Dobbins v. Commissioners, 16 Pet. 435, that a State could not tax the salaries of officers of the United States. Mr. Justice Nelson, in delivering judgment, said: 'The general government, and the States, although both exist within the same territorial limits, are separate and distinct sovereignties, acting separately and independently of each other, within their respective spheres. The former in its appropriate sphere is supreme; but the States within the limits of their powers not granted, or, in the language of the tenth amendment, "reserved", are as independent of the general government as that government within its sphere is independent of the States.'

"This is quoted in Van Brocklin v. Tenn., 117 U. S. 151, 178, and the opinion continues: 'Applying the same principles, this court, in United States v. Railroad Company, 17 Wall. 322, held that a municipal corporation within a State could not be taxed by the United States on the dividends or interest of stock or bonds held by it in a railroad or canal company, because the municipal corporation was a representative of the State, created by the State to exercise a limited portion of its powers of government, and therefore its revenues, like those of the State itself, were not taxable by the United States. *The revenues thus adjudged to be exempt from Federal taxation were not themselves appropriated to any specific public use, nor derived from property held by the State or by the municipal corporation for any specific public use, but were part of the general income of that corporation, held for the public use in no other sense than all property and income, belonging to it in its municipal character, must be so held.* The reasons for exempting all the property and income of a State, or of a municipal corporation, which is a political division of the State, from Federal taxation, equally require the exemption of all the property and income of the national government from state taxation.' "

It is not necessary to dwell upon the Baltimore case, *supra*, where a similar question was involved, for the reason that this Court has already placed its construction upon that case in the language we have italicized above.

There have been several attempts on the part of the states to tax lands belonging to the United States. (*Van Brocklin v. Tenn.*, 117 U. S. 151; *Wisconsin Central Railroad Company v. Price County*, 133 U. S. 496; *Lee*

v. Osceola Improvement District, 268 U. S. 643.) Each and all of these efforts have failed.

The courts have uniformly held that the states and their political subdivisions have no power or authority to impose a tax upon lands held in the name of the United States, and this is true even though such lands are held by the United States in its proprietary rather than its sovereign capacity. (*Woodruff v. North Bloomfield Gravel Co.,* 18 Fed. 754.) While there have been numerous attempts on the part of the states and their political subdivisions to tax the lands of the Federal Government, there has not been so far as our search reveals even an attempt on the part of the Federal Government to tax any lands belonging to a state or one of its political subdivisions. The very reasons that forbid the one forbid the other. They are alike repugnant to the established conception of the dual sovereignty of the several states and of the United States. Chief Justice Taft summarized the rule in *Irwin v. Wright,* 258 U. S. 219, where he said at page 228:

> "The rule established by the decisions of this court is that, by virtue of the sovereignty and constitutional power of Congress to dispose of and make all needful rules and regulations respecting the territory or other property belonging to the United States, no state can tax the property of the United States within its limits."

Does not a state have the power "to dispose of and make all needful rules and regulations respecting the territory or other property belonging to the" state or of one of its political subdivisions operating through a charter granted by the state? Such power is inherent to sovereignty.

Such power was never relinquished by the states to the Federal Government. The Federal Government recognized this when in its Act of August 5, 1861, levying a direct tax apportioned in conformity with the Constitution it provided in section 13 of the Act as follows:

> "Provided however that all property of whatever kind, coming within any of the foregoing description, and belonging to the United States or any state, either permanently or specially exempted from taxation by the laws of the state wherein same may be situated at the time of the passage of this Act * * * shall be exempted from the aforesaid enumeration and valuation and from the direct tax aforesaid."

Section 1 of article XIII of the Constitution of the state of California provides that property belonging to the "United States, this state, or to any county, city and county, or municipal corporation within this state shall be exempt from taxation". Section 12 of article XIX of the Constitution of the state of California provides as follows:

> "The Legislature shall have no power to impose taxes upon counties, states, or other public or municipal corporations, or upon the inhabitants or property thereof for county, city, town or other municipal purposes. * * *."

There have been a large number of acts levying direct taxes upon land in the United States enacted by Congress during the history of our country, and so far as we are aware no attempt has ever been made to levy a tax upon land belonging to a municipality. The acts have always recognized the constitutional limitation by expressly exempting such property from the provisions of the acts.

(B) THE DECISION OF THE COURT BELOW DOES NOT INVOLVE AN EXTENSION OF THE IMMUNITY OF STATE INSTRUMENTALITIES FROM FEDERAL TAXATION.

The Commissioner, in his petition, states:

> "The decision of the court below involves a radical extension of the immunity of State instrumentalities from Federal taxation. Such immunity is extended in this case to the lessee of oil lands owned by a municipality which were not devoted to a governmental purpose, without proof that the royalties payable to the city under the provisions of the lease were to be devoted to any governmental purpose."

This statement, it is respectfully submitted, fails to recognize the significance of the Findings of Fact of the Board of Tax Appeals which show distinctly that the city's purpose in acquiring the land was to clean up the unsanitary conditions then existing in its water supply, to improve the streets and to provide adequate pressure for fighting fires. It was the lack of sanitary conditions, the lack of adequate pressure for fire fighting purposes and the lack of wholesome water for its inhabitants that prompted the city to issue bonds for the purpose of acquiring the water lands. The record discloses that the lands have ever since been used for the purposes for which they were acquired. In addition thereto, the land has been devoted to other uses which did not interfere with the city's water systems.

The city of Long Beach was created for the purpose of protecting the life, liberty and property of its citizens and promoting their general welfare. The protection of life includes necessarily the protection of health which

can be attained only by eliminating unsanitary conditions and the maintenance of clean environment and safe highways for travel. It also includes protection of life and property by guarding against destructive fires which can only be accomplished by having proper fire fighting apparatus supported by an adequate and reliable water supply.

This Honorable Court has held that:

> "No higher police duty rests upon municipal authority than that of furnishing an ample supply of pure and wholesome water for public and domestic uses. The preservation of the health of the community is best obtained by the discharge of this duty, to say nothing of the preservation of property from fire, so constant an attendant upon crowded conditions of municipal life."
>
> *City of Columbus v. Mercantile Trust & Deposit Company of Baltimore,* 218 U. S. 645, 54 L. ed. 1193.

It is the established law in the state of California that the activity of the city in the protection against or extinguishment of fires and the maintenance of public streets and roads are governmental functions.

Denning v. State, 123 Cal. 316;
Davoust v. City of Alameda, 149 Cal. 69.

See also:

Chicago, B. & Q. Railroad Co. v. Illinois ex rel. Grimwood, 200 U. S. 561, 50 L. ed. 596.

The record conclusively establishes the fact that the city of Long Beach acquired and held its lands for at least three governmental purposes, to-wit: protection against

fire, protection of health and maintenance of streets. The Commissioner, in his brief before the Circuit Court of Appeals (page 27), specifically admitted that fire protection is a governmental function. The "furnishing of an ample supply of pure and wholesome water for public and domestic purposes" is also a governmental function, but even conceding that the furnishing of pure and wholesome water was in the nature of a so-called proprietary function, nevertheless, that would not be sufficient reason to deny to Taxpayer the application of the principles herein contended for.

The argument now advanced by the Commissioner was advanced by the state of Maryland in the famous case of *McCulloch v. Maryland*, 4 Wheat. 316. Mr. Hopkinson, representing the state of Maryland, argued that it was no essential governmental function for the United States to charter and regulate a national bank, and particularly was it outside the constitutional powers of the Federal Government to do so since the branch of the national bank was actually engaged in business and competing with local banks. Mr. Webster, who represented the Federal Government, stated in his brief, page 330:

> " * * * A bank may not be, and is not, absolutely essential to the existence and preservation of the government. But it is essential to the existence and preservation of the government that Congress should be able to exercise its constitutional powers at its own discretion, without being subject to the control of state legislation. The question is not whether a bank be necessary, or useful, but whether Congress may not constitutionally judge of that necessity or utility; and whether, having so judged and decided, and having adopted measures to carry its

decision into effect, the state governments may interfere with that decision, and defeat the operation of its measures. * * *."

The argument of Mr. Webster was adopted by Chief Justice Marshall wherein he stated at pages 409 and 410:

"The government which has a right to do an act, and has imposed on it the duty of performing that act, must, according to the dictates of reason, be allowed to select the means; and those who contend that it may not select any appropriate means, that one particular mode of effecting the object is excepted, take upon themselves the burden of establishing that exception."

At page 411:

"* * * No city was ever built with the sole object of being incorporated, but is incorporated as affording the best means of being well governed. * * *."

At pages 415 and 416:

"* * * To have prescribed the means by which government should, in all future time, execute its powers, would have been to change, entirely, the character of the instrument, and give it the properties of a legal code. It would have been an unwise attempt to provide, by immutable rules, for exigencies which, if foreseen at all, must have been seen dimly, and which can be best provided for as they occur. To have declared that the best means shall not be used, but those alone without which the power given would be nugatory, would have been to deprive the legislature of the capacity to avail itself of experience, to exercise its reason, and to accommodate its legislation to circumstances. If we apply this

> principle of construction to any of the powers of the government, we shall find it so pernicious in its operation that we shall be compelled to discard it. * * *."

At page 421:

> "* * * Let the end be legitimate, let it be within the scope of the constitution, and all means which are appropriate, which are plainly adapted to that end, which are not prohibited, but consist with the letter and spirit of the constitution, are constitutional."

In view of the foregoing, it is respectfully submitted, that the record disproves the statement in the Commissioner's brief, to-wit: that the "lands were not devoted to a governmental purpose". The Commissioner should, as he did before the Appellate Court, recognize at least the element of the exercise of a governmental function in the acquisition of the lands. It is believed that the record conclusively demonstrates that the lands were acquired and were used for governmental purposes, but even assuming that there was an element of a proprietary function still that would not be sufficient reason for overruling the lower court's opinion. The question the Commissioner desires this Court to pass on was presented to this Honorable Court more than one hundred years ago. The branch bank of the United States (referred to in the case of *McCulloch v. State of Maryland*, 4 Wheat. 316) operating at Baltimore was not only a Federal depositary created under the National Banking Act, but was also engaged in a general banking business in competition with local banks. In commenting on the famous case of *McCulloch v. State of Maryland*, this Honorable Court in

Osborn v. United States, 9 Wheaton 738, 6 L. ed. 204, stated at page 860:

> "* * * The whole opinion of the court, in the case of McCulloch v. The State of Maryland, is founded on, and sustained by, the idea that the bank is an instrument which is 'necessary and proper for carrying into effect the powers vested in the government of the United States,' It is not an instrument which the government found ready-made, and has supposed to be adapted to its purposes; but one which was created in the form in which it now appears, for national purposes only. It is, undoubtedly, capable of transacting private as well as public business. While it is the great instrument by which the fiscal operations of the government are effected, it is also trading with individuals for its own advantage. The appellants endeavor to distinguish between this trade and its agency for the public, between its banking operations and those qualities which it possesses in common with every corporation, such as individuality, immortality, etc. While they seem to admit the right to preserve this corporate existence, they deny the right to protect it in its trade and business."

And at page 867:

> "* * * If the trade of the bank be essential to its character as a machine for the fiscal operations of the government, that trade must be as exempt from state control as the actual conveyance of the public money. Indeed, a tax bears upon the whole machine; as well upon the faculty of collecting and transmitting the money of the nation, as on that of discounting the notes of individuals. No distinction is taken between them."

The Federal Government had only the implied right to create a bank while in the case at bar the city of Long Beach had specific authority in its charter and in the Constitution of the state to own and use the land. The state Constitution forbids the taxing of the land. If the contention now made by the Commissioner were sound, we would not have had the decision in the famous McCulloch case. This Honorable Court has repeatedly held that the purchase by a city of securities of a private corporation was an exercise of a governmental function. (*United States v. Baltimore & Ohio Railroad Company*, 84 U. S. 322, 21 L. ed. 597.)

The city's ownership of bonds is no more sacred and no more a sovereign right than its ownership of land, even though that land be revenue-producing. A municipal bond is property of the city; likewise, the land in this case is property of the city. Neither logic nor common sense could make a distinction between them insofar as the sovereign right is concerned; "* * * as to the income from municipal bonds, that could not be taxed because of want of power to tax the source;" *as to the income from the city's land, that could not be taxed because of want of power to tax the source.*

> "* * * And it follows, that if the revenue derived from municipal bonds cannot be taxed because the source cannot be, the same rule applies to revenue *from any other source not subject to tax.*" (Italics ours.)

It is seen that the principles raised by the Commissioner in his petition for writ of *certiorari* have been settled by this Honorable Court in many, many decisions over a period of the past one hundred years.

It is recognized by historians and biographers that the opinion of the immortal Marshall in the McCulloch case vitalized the Constitution. The necessity for the perpetuation of the principal in this case is just as urgent today (and perhaps more so) as it was in Marshall's time. The Commissioner would have this Court again pass upon this question so long established and would have this Court interpret the Constitution with the strictness of a code of law. The "liberal application of the foregoing principles * * * is essential to the preservation of the constitutional limitation." (*The Macallen Co. v. Massachusetts*, 279 U. S. 620.) The Constitution is not to be interpreted with the strictness of a code of law or a private contract. The provisions for the protection of life, liberty and property are to be largely and liberally construed.

The decision of the lower court does not, it is most respectfully submitted, extend the immunity doctrine; it merely recognizes the interpretations placed upon the Constitution by this Honorable Court for over a period of one hundred years and which interpretations have become as much a part of the Constitution as the written words therein. The decision of the lower court is well within the periphery of established principles that one sovereign may not tax the income derived by a lessee of the other. Instead of being an extension of the doctrine, the record brings the decision right to the core of the immunity doctrine. This is emphasized by the following excerpt from the Court's opinion:

> "As we understand it, it is not contended by the Commissioner that the forty per cent royalty paid to the city is taxable as income derived by it from its lands held in a proprietary capacity, nor, indeed,

> do we see how such a claim could be made in view of the early decision of the Supreme Court of the United States in *U. S. v. Baltimore & Ohio Ry. Co.*, 17 Wall. 322, wherein the Supreme Court held that the revenue derived by a state from bonds of the B. & O. Ry. Co., owned by it, were not taxable by the federal government, although the bonds were issued to the city to secure the repayment to the city of $5,000.00 loaned by the city to the B. & O. Ry. Co., to enable it to extend its facilities for transportation with a view of aiding the city in securing a portion of the commerce flowing from the West to the East. *The general purpose of the city of Baltimore in purchasing the bonds of the Baltimore & Ohio Railway Company was much less closely related to the governmental functions of the city than the acquisition by the city of Long Beach of water-bearing lands and a water distributing system for the inhabitants thereof, and for their fire protection.*" (Italics ours.)

It is thoroughly settled that income derived from municipal bonds is exempt from taxation because such a tax is in effect a tax on the power of the states and their instrumentalities to borrow money. This, of course, is true regardless of the purpose for which the bonds were issued and without reference to the question of whether or not the bonds were issued by the city or state for the purpose of acquiring property to be held by it in its proprietary capacity.

If, in the determination of the taxability of income from a municipal bond, it should be held that an inquiry could be made into what the proceeds of the bonds were used for, then, of course, endless litigation would arise and the immunity doctrine so vital to our Constitution would

be defeated; it would devitalize the Constitution. To lay a tax upon the A. T. Jergins Trust as an instrumentality of the city of Long Beach, or to inquire into the use of the funds by the city of Long Beach is "derogatory to the latter's dignity, subversive of its powers and repugnant to its paramount authority."

The decision of the lower court, it is respectfully submitted, will not impair the revenues of the Government. It is doubtful if another case similar to the case at bar will ever arise. The reasons for the application of the immunity doctrine to the case at bar are stronger and more compelling than the reasons supporting the case of *United States v. Baltimore & Ohio Railroad Company*, 84 U. S. 597, which was decided by this Honorable Court on April 7, 1873. The Board of Tax Appeals' decision in the case at bar was based upon its decision in the case of *Coronado Oil & Gas Company v. Commissioner of Internal Revenue*, 14 B. T. A. 1214 (50 Fed. (2d) 998), which was reversed by the Court of Appeals for the District of Columbia, the latter decision having been affirmed by this Honorable Court on April 11, 1932.

As heretofore stated, Question No. 2 relating to the deduction for depreciation of the amounts expended for drilling, *et cetera*, was not considered by the lower court because Taxpayer's entire income was held to be exempt from taxation. This question is likewise academic in this proceeding.

In conclusion, it is respectfully submitted:

1. That the decision of the lower court is supported by the established principles of law affirmed and reaffirmed during the past century by this Honorable Court.

2. That the decision is not an extension of the immunity doctrine repeatedly enunciated by this Honorable Court.

3. That the record in the case at bar shows very clearly that instead of the decision being an extension it is well within the periphery of established principles that one sovereign may not tax the income derived by the lessee of the other; instead of being an extension of the doctrine, it is respectfully submitted that the record in this case brings the decision right to the core of the immunity doctrine.

4. The decision of the lower court was in effect affirmed by this Honorable Court in its decision in the case of *David Burnet, Commissioner of Internal Revenue v. Coronado Oil & Gas Company*, 285 U. S. 393.

5. The decision of the lower court is not likely to impair the revenues of the Government.

In view of the foregoing, Taxpayer respectfully prays that the petition for writ of *certiorari* be denied.

Respectfully submitted,

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APPENDIX.

United States Constitution—Implied Provisions.

Constitution of the state of California:

"Article XIII, Sec. 1. Taxation to be in proportion to value. All property in the state except as otherwise in this Constitution provided, not exempt under the laws of the United States, shall be taxed in proportion to its value, to be ascertained as provided by law, or as hereinafter provided. * * *; and further provided, that property used for free public libraries and free museums, growing crops, property used exclusively for public schools, and such as may belong to the United States, this state, or to any county, city and county, or municipal corporation within this state shall be exempt from taxation, * * *."

Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 254:

"Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

Section 213 of the Revenue Act of 1924, c. 234, 43 Stat. 253, 267, 283 (U. S. C., Title 26, Secs. 954 and 985) contain provisions substantially the same as those of the corresponding section of the 1921 Act above quoted.

Due service of the within Brief is hereby acknowledged this.....day of December, A. D. 1932.

_____

_____

Attorneys for Petitioner.

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IN THE

SUPREME COURT

OF THE

UNITED STATES.

October Term, 1932

No. 541.

David Burnet, Commissioner of Internal Revenue,
Petitioner,

vs.

A. T. Jergins Trust,
Respondent.

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS, NINTH CIRCUIT.

BRIEF FOR RESPONDENT.

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IN THE

SUPREME COURT

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October Term, 1932

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David Burnet, Commissioner of Internal Revenue,

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vs.

A. T. Jergins Trust,

Respondent.

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS, NINTH CIRCUIT.

BRIEF FOR RESPONDENT.

I.

Opinions Below.

The opinion of the United States Board of Tax Appeals [R. 115-124] is reported in 22 B. T. A. 551.* The opinion of the United States Circuit Court of Appeals, Ninth Circuit [R. 182-187], is reported in 61 Fed (2d) 92.

* Taxpayer sought review of the Board's decision in holding that its income was not immune from taxation while the Commissioner sought review of the Board's decision holding that Taxpayer was entitled to depreciation on its intangible costs of developing oil property. Both cases, however, were heard together by the Circuit Court of Appeals and the Circuit Court of Appeals having held that the income was exempt, that, therefore, the appeal raised by the Commissioner became academic.

II.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered September 8, 1932. [R. 187.] The petition for writ of certiorari was filed December 8, 1932. The jurisdiction of this court is invoked under section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

III.

Questions Presented.

1. Whether, under the Federal Constitution and the Constitution of the state of California, the income derived by Taxpayer from the development and operation of land belonging to the city of Long Beach pursuant to a lease for a definite period is immune from federal taxation.

2. Are expenditures for wages, fuel, repairs, hauling, et cetera, in connection with development and drilling of oil wells, capital expenditures subject to depreciation?

Question No. 2 becomes academic if Question No. 1 is answered in Taxpayer's favor.

IV.

Statutes and Constitutions Involved.

These are set forth in the appendix, *infra*, page 41.

V.
STATEMENT OF THE CASE.

(1)
History of the Case.

This controversy originated by a deficiency letter issued by the Commissioner of Internal Revenue (referred to herein as the Commissioner) dated May 28, 1927 [R. 60-71], proposing a deficiency in income taxes against Respondent (hereinafter sometimes referred to as Taxpayer) for the years 1922, 1923 and 1924 amounting to the sum of $65,953.88. The Respondent appealed to the United States Board of Tax Appeals, which appeal contained two issues, to-wit:

> (1) Whether the income derived by Taxpayer was immune from taxation, and
>
> (2) Whether Taxpayer was entitled to depreciation or depletion on intangible development costs.

On the 5th day of March, 1931, the United States Board of Tax Appeals rendered its opinion where it, on authority of its own decision in *Coronado Oil & Gas Company v. Commissioner*, 14 B. T. A. 1214, held that the income derived by Taxpayer was not immune from taxation and that Taxpayer was entitled to depreciation rather than depletion allowances on the intangible development costs. Taxpayer appealed to the Circuit Court of Appeals from the Board's decision holding that Taxpayer's income was not immune from taxation and the Commissioner appealed from the Board's decision holding that Taxpayer was entitled to depreciation rather than depletion deductions on intangible development costs. The

decision of the Board of Tax Appeals in the case of *Coronado Oil & Gas Company v. Commissioner,* 14 B. T. A. 1214, was reversed by this Court on the 11th day of April, 1932, and the Circuit Court of Appeals on the 8th day of September, 1932, decided that the income of Taxpayer was exempt from taxation. Having so held, the Circuit Court did not pass upon the question raised by the Commissioner in his appeal.

(2)

Facts Involved.

The Findings of Fact made by the United States Board of Tax Appeals [R. 98-115] established, among others, the following facts:

For some years prior to 1911 the city of Long Beach had obtained its water supply from independent water companies which in turn obtained their water from subterranean sources through artesian wells on land located approximately three miles north of the city of Long Beach. The water mains of these companies were made of such material that water escaped therefrom and caused mudholes in the streets. When it was necessary to shut the water off from the mains outside water would seep back into them and contaminate the water which thereafter came through them for the use of the city and its citizens. [R. 98.] The escaping water became stagnant and created unsanitary conditions. The mains could not resist sufficient pressure to enable the fire department to fight fires. To correct these conditions the city, in 1911, by public vote, authorized a bond issue for the purpose of acquiring these water lands and water systems. With

the money thus obtained the city, in 1911, acquired about 600 acres of this land which has ever since been used by the city as a source of water supply. [R. 99.]

The Respondent was created in April, 1922, by virtue of a declaration of trust executed under and pursuant to the laws of the state of California, for the purpose of entering into an oil and gas lease with the city of Long Beach. On April 11, 1922, oil having been discovered in the vicinity of Long Beach, the city of Long Beach, as lessor, and Taxpayer, as lessee, entered into an oil and gas lease on approximately 140 acres of its water lands. The lease, among other things, provided [R. 100-108]:

(1) That Taxpayer would receive 60% of the proceeds derived from the oil and gas and the city would receive the balance or 40%;

(2) That Taxpayer was to pay all taxes on properties placed by it on the premises and 60% of all taxes levied by the State or Federal Government;

(3) That no structure should be erected within 150 feet of any reservoir;

(4) That no work should be done on west half farm lot 59 without the consent of the City Manager;

(5) That the lessee should operate so as to interfere as little as possible with reserved uses of lessor;

(6) That the lessee should protect all waterworks of lessor against any and all damage.

For the protection of its rights under the lease, the city during the years in question, maintained on the property a laboratory for the purpose of testing all the oil and gas produced; the city employed an oil engineer whose duty it was to see that Taxpayer performed and did not vio-

late its contractual duties and to see that the city obtained the maximum amount to which it was entitled under the lease. [R. 109.] The oil and gas recovered from said premises have been sold under a joint contract of the city and Taxpayer as provided in the lease. Tests were made of the runs of oil. Conferences between Taxpayer's representatives and the city authorities have been generally held whenever the location of a new well was to be determined.

In 1922 all of Taxpayer's gross income was derived from oil and gas produced under the lease. In 1923 $985,790.34 was so derived, and in 1924 $1,935,376.82. [R. 109-110.] The Board of Tax Appeals held that the United States could tax that income, and sustained the Commissioner's determination to that extent. [R. 118.]

There was also submitted to the Board the question whether certain capitalized sums expended by the Taxpayer for drilling costs and development expense in connection with oil wells were returnable to Taxpayer through a depletion or a depreciation allowance. [R. 113-115.] The Commissioner had treated such sums as subject only to a depletion allowance, but the Board held that they were subject to depreciation allowance. [R. 120-123.]

The Taxpayer appealed from the portion of the Board's decision holding that its income derived from the oil lease on city lands was taxable, and the Commissioner appealed from the portion of the Board's decision allowing deduction of capitalized costs as depreciation. The Circuit Court of Appeals for the Ninth Circuit held that the tax proposed by the Commissioner could not constitutionally be imposed upon the income derived by the Taxpayer

from the sale of oil taken from the land leased by the city, and concluded that the assessment of the Commissioner should be set aside. Accordingly, the Court did not pass upon the question presented by the Commissioner's appeal as that question then became academic.

As to Deductions for Depreciation.

During 1922 the respondent expended $59,376.86 for physical equipment, and $102,508.85 for wages, fuel, repairs, hauling, et cetera, in connection with development and drilling. [R. 113.] The full amount of these expenses, $161,885.81, was capitalized in the determination of the deficiency for the year 1922. [R. 114.]

During the year 1923 Respondent expended $260,313.62 for physical equipment, and $431,393.11 for wages, fuel, repairs, hauling, et cetera, in connection with development and drilling. The full amount, $691,706.73, was capitalized in the determination of the deficiency for the year 1923. [R. 114.]

During the year 1924 the Respondent expended $303,244.69 for physical equipment, and $452,226.75 for fuel, repairs, hauling, et cetera, in connection with development and drilling. The full amount, $755,471.44, was capitalized in the determination of the deficiency for 1924 [R. 114.]

The Petitioner allowed depreciation only on the amounts expended for physical equipment, and added the drilling expenses to sums recoverable through depletion. [R. 114.] He computed Respondent's depreciation allowance for 1924 based upon cost of leaseholds and development cost plus discovery value at the amount of $1,228,864.99, and allowed a deduction of $771,982.99. [R. 114-115.]

VI.

Summary of Argument.

It is well settled that under the Federal Constitution neither the Federal Government nor the states may tax the property of the other. This Court in the case of *Lee v. Osceola Improvement District*, 268 U. S. 643, at page 645, stated:

> "It was settled many years ago that the property of the United States is exempt by the Constitution from taxation under the authority of a state so long as title remains in the United States."

The income here involved is the income from city owned land.

It is equally well settled that if the land cannot be taxed then the revenue derived therefrom cannot be taxed. It is likewise well settled that neither the Federal Government nor the state government may tax the instrumentalities of the other.

Pollock v. Farmers Loan and Trust Company, 157 U. S. 429, 158 U. S. 601;

Indian Territory Illuminating Oil Co. v. Oklahoma, 240 U. S. 522;

Union Pacific Railroad Company v. Peniston, 18 Wall. 5;

United States v. Baltimore & Ohio Railroad Company, 17 Wall. 322, 21 L. Ed. 597;

Collector v. Day, 11 Wall. 113;

McCulloch v. Maryland, 4 Wheat. 316;

Gillespie v. State of Oklahoma, 257 U. S. 501;

Burnet v. Coronado Oil & Gas Co., 285 U. S. 393, 76 L. Ed. 815.

The principle that the Federal Government may not tax the property of a state or the income therefrom applies whether the land is held by the sovereign in a proprietary or a so-called governmental capacity.

Woodruff v. North Bloomfield Gravel Co., 18 Fed. 754-772;

Irwin v. Wright, 258 U. S. 219;

Van Brocklin v. Tenn., 117 U. S. 151;

Wisconsin Central Railroad Co. v. Price County, 133 U. S. 496;

Lee v. Osceola Improvement District, 268 U. S. 643.

The land owned and leased by the city of Long Beach to Taxpayer was part of a tract acquired and used by the city of Long Beach in its governmental capacity inasmuch as it was purchased in 1911 by the city of Long Beach in order to:

(1) Improve its streets;

(2) Eliminate unsanitary conditions;

(3) Protect the health of the community;

(4) Provide adequate water and pressure for fighting fires, and

(5) To assure a clean and wholesome supply of water for its inhabitants.

The same considerations that invalidate a tax on the city's lease invalidate a tax upon the profits derived by the A. T. Jergins Trust from the lease; that the city's profit from the lease will be diminished to some extent by the requirement that the lessee pay a tax upon its income derived from the city's property is as clear in the case at

bar as in those cases wherein the right of the Federal or state government to tax proceeds from publicly owned lands has been denied. A tax on the instrumentality of the city of Long Beach is "derogatory to the latter's dignity, subversive of its powers and repugnant to its paramount authority."

VII.

ARGUMENT.

The Decision of the Ninth Circuit Court of Appeals in This Case Is Merely the Affirmation of Constitutional Principles Recognized by This Honorable Court for More Than a Century.

The case at bar arises because of two sovereigns established in the same territory, the state and the United States (the city of Long Beach is merely exercising delegated state sovereign powers). The taxing power of both on subjects which they may tax is unlimited. If one may tax the other at all, there is no limit as to how much it may so tax it. As has been truly stated, if one may tax the other "lightly" it may do so "heavily, if justly, oppressively," or as has also been stated, if one may tax the other at all it may, by such power, destroy the other altogether. The power once admitted is unlimited and through it the sovereignty of each of the governments might be partially or totally destroyed by the other.

The foundation of the case is, therefore, based upon the rule which arises by reason of the separate governments and which is implied in the Constitution, that neither the states nor the United States may tax each other. It requires no argument to establish this rule of

law at this late date. It has been decided so many times that the mere statement of it brings to mind a long list of celebrated cases. (*McCullock v. Maryland*, 4 Wheat 316; *Abelman v. Booth*, 21 Howd. 506; *Collector v. Day*, 11 Wall. 113; *U. P. Ry. Co. v. Peniston*, 18 Wall. 5; *U. S. v. B. & O. Ry. Co.*, 17 Wall. 322; *Pollock v. Farmers Loan and Trust Co.*, 157 U. S. 429; *Indian Oil Co. v. Oklahoma*, 240 U. S. 522; *Gillespie v. Oklahoma*, 257 U. S. 501; *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393; 76 L. Ed. 815), and many others. The only difficuties which have arisen in recent times in connection with the rule have been the effort of too diligent tax gatherers, to use their own phrasing, "to whittle the rule down until it is of no more effect". There have been vicarious efforts to tax indirectly what could not be taxed directly and these efforts have uniformly been repulsed by the courts who have restated the rule and maintained its effectiveness.

These efforts have been made by seeking to tax interest on state and municipal bonds, the income from city investments, income from oil leases where the ground upon which the leases were made could not be taxed, and in other ways which would amount to burdening the United States, States, and Municipal Governments indirectly by interfering with and making it difficult and expensive for such governments to perform their ordinary obligations as sovereigns to the citizens which compose them. In every case where the attempt has been made it has been held beyond the taxing power, and an unwarranted interference with the sovereign power. These efforts led Justice Holmes to say "the rule as to instru-

mentalities of the United States * * * is absolute" (*Gillespie v. Oklahoma*, 257 U. S. 501, at page 505). The argument has been made in every case which has come before the courts that where the income belongs to a private person or corporation after it has been segregated from the nontaxable property, it is too remote to fall within the rule stated, and the answer has been over and over again that if the source cannot be taxed the income therefrom shares the same immunity.

In the famous case of *Pollock v. Farmers Loan and Trust Company*, 157 U. S. 429, on rehearing, 158 U. S. 601, at page 618, the Supreme Court said:

> "* * * As to the income from municipal bonds, they could not be taxed because of want of power to tax the source, * * *."

Further on at page 630 the Supreme Court made the following comment:

> "* * * and it follows that, if the revenue derived from municipal bonds cannot be taxed because the source cannot be, the same rule applies to revenue from any other source not subject to the tax; * * *."

The same principle is laid down as absolute in the following cases:

> *Northwestern Mutual Life Insurance Co. v. Wisconsin*, 275 U. S. 136;
>
> *Gillespie v. State of Oklahoma*, 257 U. S. 501.

In the case of *Gillespie v. State of Oklahoma*, 257 U. S. 501, the Court spoke as follows:

> "The rule as to instrumentalities of the United States, * * * is absolute in form * * *. 'A tax upon the leases is a tax upon the power to make them, and could be used to destroy the power to make them.' 240 U. S. 530. The step from this to the invalidity of the tax upon income from the leases is not long.
>
> "In cases where the principal is absolutely immune from interference, an inquiry is allowed into the sources from which net income is derived, and if a part of it comes from such a source, the tax is *pro tanto* void."

The mandate of the Supreme Court expressed in the foregoing could not be more definite:

> "The same considerations that invalidate a tax upon the leases invalidate a tax upon the profits of the leases."

In the case of *Northwestern Mutual Life Insurance Company v. Wisconsin*, 275 U. S. 136, the Supreme Court said at page 140:

> "Certainly, since Gillespie v. Oklahoma, 257 U. S. 501, 505, it has been the settled doctrine here that where the principal is absolutely immune, no valid tax can be laid upon income arising therefrom."

The source of the revenue in this case was the land belonging to the city of Long Beach. Even disregarding for a moment the circumstances under which and purposes for which the land in question was acquired and

used by the city, could the Federal Government lawfully and constitutionally impose a tax upon that land?

In the case of *Pollock v. Farmers Loan and Trust Company*, 157 U. S. 429, at page 584, we find the following language which is at once expressive of the reasoning and the decision of the Court in that case:

> "As the States cannot tax the powers, the operations, or the property of the United States, nor the means which they employ to carry their powers into execution, so it has been held that the United States have no power under the Constitution to tax either the instrumentalities or the property of a State.
>
> "A municipal corporation is the representative of the State and one of the instrumentalities of the state government. It was long ago determined that the property and revenues of municipal corporations are not subjects of Federal taxation. Collector v. Day, 11 Wall. 113, 124; United States v. Railroad Company, 17 Wall. 322, 332. In Collector v. Day, it was adjudged that Congress had no power, even by an act taxing all incomes, to levy a tax upon the salaries of judicial officers of a State, for reasons similar to those on which it had been held in Dobbins v. Commissioners, 16 Pet. 435, that a State could not tax the salaries of officers of the United States. Mr. Justice Nelson, in delivering judgment, said: 'The general government, and the States, although both exist within the same territorial limits, are separate and distinct sovereignties, acting separately and independently of each other, within their respective spheres. The former in its appropriate sphere is supreme; but the States within the limits of their powers not granted, or, in the language of the tenth amendment, "reserved", are as independent

of the general government as that government within its sphere is independent of the States.'

"This is quoted in Van Brocklin v. Tenn., 117 U. S. 151, 178, and the opinion continues: 'Applying the same principles, this court, in United States v. Railroad Company, 17 Wall. 322, held that a municipal corporation within a State could not be taxed by the United States on the dividends or interest of stock or bonds held by it in a railroad or canal company, because the municipal corporation was a representative of the State, created by the State to exercise a limited portion of its powers of government, and therefore its revenues, like those of the State itself, were not taxable by the United States. *The revenues thus adjudged to be exempt from Federal taxation were not themselves appropriated to any specific public use, nor derived from property held by the State or by the municipal corporation for any specific public use, but were part of the general income of that corporation, held for the public use in no other sense than all property and income, belonging to it in its municipal character, must be so held.* The reasons for exempting all the property and income of a State, or of a municipal corporation, which is a political division of the State, from Federal taxation, equally require the exemption of all the property and income of the national government from state taxation.'" (Italics ours.)

Incidentally, the language italicized by us above ought to be a sufficient answer to the objection offered by the Commissioner to the effect that the income here involved is not dedicated to any particular public use.

There have been several attempts on the part of the states to tax lands belonging to the United States. (*Van*

Brocklin v. Tenn., 117 U. S. 151; *Wisconsin Central Railroad Company v. Price County*, 133 U. S. 496; *Lee v. Osceola Improvement District*, 268 U. S. 643.) Each and all of these efforts have failed.

The courts have uniformly held that the states and their political subdivisions have no power or authority to impose a tax upon lands held in the name of the United States, and this is true even though such lands are held by the United States in its proprietary rather than its sovereign capacity. (*Woodruff v. North Bloomfield Gravel Co.*, 18 Fed. 754.) While there have been numerous attempts on the part of the states and their political subdivisions to tax the lands of the Federal Government, there has not been so far as our search reveals even an attempt on the part of the Federal Government to tax any lands belonging to a state or one of its political subdivisions. The very reasons that forbid the one forbid the other. They are alike repugnant to the established conception of the dual sovereignty of the several states and of the United States. Chief Justice Taft summarized the rule in *Irwin v. Wright*, 258 U. S. 219, where he said at page 228:

> "The rule established by the decisions of this court is that, by virtue of the sovereignty and constitutional power of Congress to dispose of and make all needful rules and regulations respecting the territory or other property belonging to the United States, no state can tax the property of the United States within its limits."

Does not a state have the power "to dispose of and make all needful rules and regulations respecting the territory or other property belonging to the" state or of one of its

political subdivisions operating through a charter granted by the state? Such power is inherent to sovereignity. Such power was never relinquished by the states to the Federal Government. The Federal Government recognized this when in its Act of August 5, 1861, levying a direct tax apportioned in conformity with the Constitution it provided in section 13 of the Act as follows:

> "Provided however that all property of whatever kind, coming within any of the foregoing description, and belonging to the United States or any state, either permanently or specially exempted from taxation by the laws of the state wherein same may be situated at the time of the passage of this Act * * * shall be exempted from the aforesaid enumeration and valuation and from the direct tax aforesaid."

Section 1 of article XIII of the Constitution of the state of California provides that property belonging to the "United States, this state, or to any county, city and county, or municipal corporation within this state shall be exempt from taxation". Section 12 of article XIX of the Constitution of the state of California provides as follows:

> "The Legislature shall have no power to impose taxes upon counties, states, or other public or municipal corporations, or upon the inhabitants or property thereof for county, city, town or other municipal purposes. * * *."

There have been a large number of acts levying direct taxes upon land in the United States enacted by Congress

during the history of our country, and so far as we are aware no attempt has ever been made to levy a tax upon land belonging to a municipality. The acts have always recognized the constitutional limitation by expressly exempting such property from the provisions of the acts.

THE DECISION OF THE COURT BELOW DOES NOT INVOLVE AN EXTENSION OF THE IMMUNITY OF STATE INSTRUMENTALITIES FROM FEDERAL TAXATION.

The Commissioner, in his petition, states:

> "The decision of the court below involves a radical extension of the immunity of State instrumentalities from Federal taxation. Such immunity is extended in this case to the lessee of oil lands owned by a municipality which were not devoted to a governmental purpose, without proof that the royalties payable to the city under the provisions of the lease were to be devoted to any governmental purpose."

The lower court's decision, as we view it, does not in any manner involve an extension of the doctrine of immunity of State instrumentalities. It holds that land belonging to a municipality is immune, and that a tax upon the income of the land, being a tax upon the land itself, bears the same immunity. The court also holds that the ownership of the land is closely related to governmental activities.

The statement of the Commissioner, it is respectfully submitted, fails to recognize the significance of the Findings of Fact of the Board of Tax Appeals, which show distinctly that the city's purpose in acquiring the land was to clean up the unsanitary conditions then existing in its water supply, to improve the streets and to provide ade-

quate pressure for fighting fires. It was the lack of sanitary conditions, the lack of adequate pressure for fire fighting purposes and the lack of wholesome water for its inhabitants that prompted the city to issue bonds for the purpose of acquiring the water lands. The record discloses that the lands have ever since been used for the purposes for which they were acquired. In addition thereto, the land has been devoted to other uses which did not interfere with the city's water systems.

The city of Long Beach was created for the purpose of protecting the life, liberty and property of its citizens and promoting their general welfare. The protection of life includes necessarily the protection of health which can be attained only by eliminating unsanitary conditions and the maintenance of clean environment and safe highways for travel. It also includes protection of life and property by guarding against destructive fires which can only be accomplished by having proper fire fighting apparatus supported by an adequate and reliable water supply.

This Honorable Court has held that:

> "No higher police duty can rest upon municipal authority than that of furnishing an ample supply of pure and wholesome water for public and domestic uses. The preservation of the health of the community is best obtained by the discharge of this duty, to say nothing of the preservation of property from fire, so constant an attendant upon crowded conditions of municipal life."
>
> *City of Columbus v. Mercantile Trust & Deposit Company of Baltimore*, 218 U. S. 645, 54 L. ed. 1193.

It is the established law in the state of California that the activity of the city in the protection against or extinguishment of fires and the maintenance of public streets and roads are governmental functions.

Denning v. State, 123 Cal. 316;

Davoust v. City of Alameda, 149 Cal. 69.

See also:

Chicago, B. & Q. Railroad Co. v. Illinois ex rel. Grimwood, 200 U. S. 561, 50 L. ed. 596.

The record conclusively establishes the fact that the city of Long Beach acquired and held its lands for at least three governmental purposes, to-wit: protection against fire, protection of health and maintenance of streets. The Commissioner, in his brief before the Circuit Court of Appeals (page 27), specifically admitted that fire protection is a governmental function. The "furnishing of an ample supply of pure and wholesome water for public and domestic purposes" is also a governmental function, but even conceding that the furnishing of pure and wholesome water was in the nature of a so-called proprietary function, nevertheless, that would not be sufficient reason to deny to Taxpayer the application of the principles herein contended for.

The argument now advanced by the Commissioner was advanced by the state of Maryland in the famous case of *McCulloch v. Maryland*, 4 Wheat. 316. Mr. Hopkinson, representing the state of Maryland, argued that it was no essential governmental function for the United States to charter and regulate a national bank, and particularly was it outside the constitutional powers of the Federal

Government to do so since the branch of the national bank was actually engaged in business and competing with local banks. Mr. Webster, who represented the Federal Government, stated in his brief, page 330:

> "* * * A bank may not be, and is not, absolutely essential to the existence and preservation of the government. But it is essential to the existence and preservation of the government that Congress should be able to exercise its constitutional powers at its own discretion, without being subject to the control of state legislation. The question is not whether a bank be necessary, or useful, but whether Congress may not constitutionally judge of that necessity or utility; and whether, having so judged and decided, and having adopted measures to carry its decision into effect, the state governments may interfere with that decision, and defeat the operation of its measures. * * *."

The argument of Mr. Webster was adopted by Chief Justice Marshall wherein he stated at pages 409 and 410:

> "The government which has a right to do an act, and has imposed on it the duty of performing that act, must, according to the dictates of reason, be allowed to select the means; and those who contend that it may not select any appropriate means, that one particular mode of effecting the object is excepted, take upon themselves the burden of establishing that exception."

At page 411:

> "* * * No city was ever built with the sole object of being incorporated, but is incorporated as affording the best means of being well governed. * * *."

At pages 415 and 416:

> "* * * To have prescribed the means by which government should, in all future time, execute its powers, would have been to change, entirely, the character of the instrument, and give it the properties of a legal code. It would have been an unwise attempt to provide, by immutable rules, for exigencies which, if foreseen at all, must have been seen dimly, and which can be best provided for as they occur. To have declared that the best means shall not be used, but those alone without which the power given would be nugatory, would have been to deprive the legislature of the capacity to avail itself of experience, to exercise its reason, and to accomodate its legislation to circumstances. If we apply this principle of construction to any of the powers of the government, we shall find it so pernicious in its operation that we shall be compelled to discard it. * * *."

At page 421:

> "* * * Let the end be legitimate, let it be within the scope of the constitution, and all means which are appropriate, which are plainly adapted to that end, which are not prohibited, but consist with the letter and spirit of the constitution, are constitutional."

In view of the foregoing, it is respectfully submitted, that the record disproves the statement in the Commissioner's brief, to-wit: that the "lands were not devoted to a governmental purpose". The Commissioner should, as he did before the Appellate Court, recognize at least the element of the exercise of a governmental function in the acquisition of the lands. It is believed that the record conclusively demonstrates that the lands were acquired and

were used for governmental purposes, but even assuming that there was an element of a proprietary function still that would not be sufficient reason for overruling the lower court's opinion. The question the Commissioner desires this Court to pass on was presented to this Honorable Court more than one hundred years ago. The branch bank of the United States (referred to in the case of *McCulloch v. State of Maryland,* 4 Wheat. 316) operating at Baltimore was not only a Federal depositary created under the National Banking Act, but was also engaged in a general banking business in competition with local banks. In commenting on the famous case of *McCulloch v. State of Maryland,* this Honorable Court in *Osborn v. United States,* 9 Wheaton 738, 6 L. ed. 204, stated at page 860:

> "* * * The whole opinion of the court, in the case of McCulloch v. The State of Maryland, is founded on, and sustained by, the idea that the bank is an instrument which is 'necessary and proper for carrying into effect the powers vested in the government of the United States.' It is not an instrument which the government found ready-made, and has supposed to be adapted to its purposes; but one which was created in the form in which it now appears, for national purposes only. It is, undoubtedly, capable of transacting private as well as public business. While it is the great instrument by which the fiscal operations of the government are effected, it is also trading with individuals for its own advantage. The appellants endeavor to distinguish between this trade and its agency for the public, between its banking operations and those qualities which it possesses in common with every corporation, such as individuality, immortality, etc. While they seem to admit the right

> to preserve this corporate existence, they deny the right to protect it in its trade and business."

And at page 867:

> "If the trade of the bank be essential to its character as a machine for the fiscal operations of the government, that trade must be as exempt from state control as the actual conveyance of the public money. Indeed, a tax bears upon the whole machine; as well upon the faculty of collecting and transmitting the money of the nation, as on that of discounting the notes of individuals. No distinction is taken between them."

The Federal Government had only the implied right to create a bank while in the case at bar the city of Long Beach had specific authority in its charter and in the Constitution of the state to own and use the land. The state Constitution forbids the taxing of the land. If the contention now made by the Commissioner were sound, we would not have had the decision in the famous McCulloch case. This Honorable Court has repeatedly held that the purchase by a city of securities of a private corporation was an exercise of a governmental function. (*United States v. Baltimore & Ohio Railroad Company*, 17 Wall. 322, 21 L. Ed. 597.)

The city's ownership of bonds is no more sacred and no more a sovereign right than its ownership of land, even though that land be revenue-producing. A municipal bond is property of the city; likewise, the land in this case is property of the city. Neither logic nor common sense could make a distinction between them insofar as the sovereign right is concerned; "* * * as to the income

from municipal bonds, that could not be taxed because of want of power to tax the source;" *as to the income from the city's land, that could not be taxed because of want of power to tax the source.*

> "* * * And it follows, that if the revenue derived from municipal bonds cannot be taxed because the source cannot be, the same rule applies to revenue *from any other source not subject to tax.*" (Italics ours.)

The Commissioner's contention has for its background the existence of numerous decisions distinguishing between strictly "governmental functions" and "proprietary functions" of political subdivisions. The distinction sometimes referred to between the so-called "governmental" and "proprietary" functions of a municipality is a creature of the courts, conceived by the judges to promote justice to injured litigants. The decline of the theory that "the King can do no wrong" and the advent of the complex municipal instrumentalities capable of much good and much harm, assisted in its development. This doctrine, created to give justice to the injured individuals, is merely a procedural rule and has been confined almost exclusively to tort cases. However, we seriously assert that in the final analysis the distinction between a strictly governmental function and the so-called proprietary function cannot be used as the criterion of interference by taxation by the Federal Government of the functions of the states.

This Honorable Court has repeatedly held that "those agencies through which either government immediately and directly exercises its sovereign powers are immune from the taxing power of the other." (*Metcalf & Eddy*

v. Mitchell, 269 U. S. 514, 70 L. Ed. 384.) The Commissioner places great reliance upon the decision of the Supreme Court in the case of *Flint v. Stone Tracy Company et al.*, 220 U. S. 107, 55 L. Ed. 389. The question involved in that case was whether or not excise taxes under the Corporation Excise Tax Act of 1909 could be levied on corporations created by the state and also whether or not a so-called public service corporation, such as the Coney Island & Brooklyn Railroad Company and the Interborough Rapid Transit Company of New York, were exempted from the operation of the statute. The Supreme Court in that case held that an excise tax could be measured by the income derived even from exempt securities and further held that the so-called public service corporations were subject to the excise tax. The statement of the Supreme Court that the supplying of water by a municipality was not a governmental function was merely dictum. The Supreme Court stated, among other things:

> "The true distinction is between the attempted taxation of those operations of the states essential to the execution of its governmental functions, and which the state can only do itself, and those activities which are of a private character."

This language, it is most respectfully submitted, is direct authority for the position taken by the A. T. Jergins Trust in the case at bar. It is recognized that state and local governments in the United States were created for the purpose of protecting the life, liberty and property of the citizens and promoting their "general welfare". The problems of protection in a modern city include not only the protection afforded by uniformed and armed police-

men but also protection against many other dangers as great if not greater than the danger of the criminal or the outlaw. The protection of life includes necessarily the protection of health, which can be secured only by the creation and maintenance of a sanitary environment. This naturally includes clean streets, clean lots, the filling of swamps and destruction of breeding places for mosquitoes, flies and other insects which carry and scatter disease germs, the construction and maintenance of safe highways for travel, the elimination of danger to travelers on account of mud holes and swampy conditions in streets. It also includes the protection of life and property by guarding against destructive fires, which can be accomplished only by the maintenance of adequate fire fighting apparatus supported by an adequate and reliable water supply. The foregoing activities are essentially the activities of a government, and when undertaken by a municipality, come clearly within the accepted and oft-repeated definition of "governmental functions".

No higher police duty rested upon the city of Long Beach than that of giving protection to its citizens against the evils existent at the time the lands were purchased. It had that duty to perform and its discretion as to how it performed that duty may not be questioned by the Federal Government.

In determining what is a governmental function or a proprietary function, we must necessarily look to the activities of the city in the light of modern tendencies. When Rome was at its zenith police protection as well as fire protection was a proprietary and not a governmental function. (See Monro Municipal Government Admin-

istration 1923, Chapter 1.) Education formerly was not a duty of a government nor was the care of public health; today courts are in agreement that these duties are governmental in character. It was not until the nineteenth century that the various states of the United States began to use municipal corporations as agencies of the state in the performance of state duties.

The Supreme Court of the state of California has consistently held that the rights of a city to water lands and river beds were essentially governmental in character. In the case of the *City of San Diego, a municipal corporation, plaintiff, v. Cuyamaca Water Company, a corporation, et al.*, 209 Cal. 105, at page 130, stated:

> "It should at the outset be understood and stated that the pueblo rights, and hence the rights of its successor, the City of San Diego, to whatever of the waters of the San Diego River were from time to time required for the needs of the pueblo and of the city and of the inhabitants of each, were rights which were essentially 'governmental' in character, as much so in fact as were the rights of the ancient pueblo and modern city to the public squares or streets, and that the term 'proprietary', as employed with reference to certain commercialized uses made by municipalities and other public bodies, of water, light and power, for example, has no application to the fundamental rights of the plaintiff herein to its ownership of its foregoing classes of property dedicated and devoted to public uses."

The case at bar is not within the purview of the Supreme Court's decisions in the cases of *South Carolina v. United States*, 199 U. S. 437, and *Salt Lake City v. Hollister*, 118 U. S. 256.

This Honorable Court's opinion in the Coronado case sufficiently answers the argument advanced by the Commissioner with respect to these cases. It is interesting to note in the South Caroline case, that this Honorable Court took great pains to state that the tax therein attempted to be collected was not a tax on property, and in this respect stated, page 458:

> "Further, it may be noticed that the tax is not imposed on any property belonging to the state, but is a charge on a business before any profits are realized therefrom.
>
> * * * * * * * *
>
> "So here, the charge is not upon the property of the state, but upon the means by which that property is acquired, and before it is acquired."

There was no constitutional question raised in the case of *Salt Lake City v. Hollister,* 118 U. S. 256. The only question involved in that case was whether or not the city could be relieved of the tax merely because its activities in distilling liquor was beyond and outside of its corporate powers. The right of the United States to tax a municipality engaged in the liquor business was not presented to the court in that case. The court held that even though the act of the city in distilling the liquor was beyond its corporate powers, nevertheless, it was subject to the tax. This case, like the South Carolina case, is not applicable to the case at bar because of the fact that the tax in the case at bar amounts to direct tax on land.

The Commissioner has urged that the city with respect to its oil lease was engaged in a commercial enterprise. Even though the incidental use made of the land by the

city may be classified in part as a commercial enterprise, nevertheless, that is not sufficient to deny the immunity. The bank in the case of *McCulloch v. Maryland*, 4 Wheat. 316, was not only acting as the Federal Government's depositary but it was also engaging in a commercial enterprise in competition with other banks. This fact, although insistently urged, did not deter this Honorable Court from holding the bank exempt from tax. Of course, every activity of a sovereign involves to a more or less extent a certain amount of "business". The Federal Government in taking over and conducting its postal department, monopolized a business that had theretofore been carried on by individuals. It might some day take over the radio and the telegraph. The numerous activities of the Federal Government in its reclamation service, Panama Canal service, Alaskan Railway, et cetera, are closely related to "business" but that does not give the state permission to tax these activities.

Even though the imagination be stretched to a point where the utilization of the city's lands by the leasing thereof to taxpayer can be classified as "engaging in business", still these activities would be within the purview of the McCulloch and the Baltimore & Ohio Railroad cases. If the city of Baltimore could, in its municipal capacity, purchase stocks of a railroad company in order to attract business to the city, and be immune from tax upon the income therefrom, then certainly the city of Long Beach may develop publicly owned lands for the benefit of the city and be likewise exempt.

The city having been given the constitutional right to own land certainly ought to be the sole judge of how that

land should be utilized. This proposition has been sustained by this Honorable Court in the case of *United States v. Baltimore & Ohio Railroad Company*, 17 Wall. 322; 21 L. ed. 597, at pages 599, 600 and 601, wherein among other things, in referring to the purchase of bonds by the city of Baltimore, it was stated:

> "* * * The right of the states to administer their own affairs through their legislative, executive, and judicial departments, in their own manner through their own agencies, is conceded by the uniform decisions of this court and by the practice of the Federal government from its organization. This carries with it an exemption of those agencies and instruments, from the taxing power of the Federal government. If they may be taxed lightly, they may be taxed heavily; if justly, oppressively. * * *
>
> * * * * * * * *
>
> "Was it exercised for the benefit of the municipality, that is, in the course of its municipal business or duties? In other words, was it acting in its capacity of an agent of the state, delegated to exercise certain powers for the benefit of the municipality called the city of Baltimore? Did it act as an auxiliary servant and trustee of the supreme legislative power? The legislature and the authorities of the city of Baltimore decided that the investment of $5,000,000 in aid of the construction of a railroad, which should bring to that city the unbounded harvests of the West, would be a measure for the benefit of the inhabitants of Baltimore and of the municipality. This vast business was a prize for which the states north of Maryland were contending. Should it endeavor by the expenditure of this money or this credit to bring this vast business into its own state, and make its com-

mercial metropolis great and prosperous, or should it refuse to incur hazard, allow other states to absorb this commerce, and Baltimore to fall into an inferior position? *This was a question for the decision of the city under the authority of the state. It was a question to be decided solely with reference to public and municipal interests.* The city had authority to expend its money in opening squares, in widening streets, in deepening rivers, in building common roads or railways. The state could do these things by the direct act of its legislature, or it could empower the city to do them. It could act directly or through the agency of others. *It is not a question to be here discussed, whether the action proposed would in the end result to the benefit of the city.* It might be wise, or it might prove otherwise. The city was to reap the fruits in the advanced prosperity of all its material interests, if successful. If unsuccessful, the city was to bear the load of debt and taxation, which would surely follow. The city had the power given it by the legislature to decide the question. It was within the scope of its municipal powers.

"This advance of the city bonds was not a donation. It was an investment supposed to be judiciously made and adequately secured. It was not for the individual benefit of those managing the business. No one received advantage except as he was a citizen or his property was within the city. It was not a loan for the benefit of the railroad; it was for the benefit of the city solely. That the railroad company was also benefited did not affect the purpose of the transaction.

* * * * * * * *

"The action is no less a portion of the sovereign authority, when it is done through the agency of a town or city corporation." (Italics ours.)

We believe that the Circuit Court of Appeals was right when it said [R. 185]:

> "The general purpose of the city of Baltimore in purchasing the bonds of the Baltimore & Ohio Railway Company was much less closely related to the governmental functions of the city than the acquisition by the city of Long Beach of water-bearing lands and a water-distributing system for the inhabitants thereof, and for their fire protection."

The Government has urged that the tax upon the lessee of the city's land is not a burden upon the city. This has been answered by this Honorable Court in the Gillespie and Coronado cases. It must be recognized that the lessee must derive profit in order to continue to obtain the oil for the city. The greater the tax the lessee has to pay the greater the profit it must obtain from the city and consequently the less the city would obtain. The tax on the lessee's income would naturally diminish the city's fund; "that the amount of this fund will be diminished to some extent by the requirement that the lessee pay a tax upon its income derived from the sale of its proportion of the oil is as clear in the case at bar as in those cases wherein the right of the Federal or State Government to tax proceeds from publicly owned oil lands has been denied". [Circuit Court Opinion R. 187.]

To permit an inquiry into the purposes for which funds derived by a city from the issuance of its bonds or other borrowings would cause turmoil and dismay. If the Federal Government may in the determination of its taxes inquire into the uses to which the funds of a city are devoted so may the states and cities inquire into the uses made of funds obtained by the Federal Government from

taxation, bonds, contracts, utilization of lands, et cetera. The states may also inquire into the functions performed by officers of the Federal Government, such as those officers connected with the reclamation service, the Panama toll service, Insular Barge Company, Muscle Shoals, post-office, et cetera. To allow an inquiry into the purposes for which the funds were devoted by the city of Long Beach would be "derogatory to the latter's dignity, subversive of its powers and repugnant to its paramount authority".

It is, therefore, respectfully submitted that the A. T. Jergins Trust was an instrumentality of the city of Long Beach and as such its income derived from the city's land was exempt. The A. T. Jergins Trust was not only the recipient of income from a source that is exempt (like a municipal bondholder) but its relations and activities were so intimately connected with the affairs of the city of Long Beach that if anything, the A. T. Jergins Trust stands in a much better position than the mere holder of a bond or an Indian lessee. There is more reason and logic for holding that the income received by the A. T. Jergins Trust is immune from taxation because of the supervisory power and control exercised over it by the city of Long Beach than there is for holding the income received by a municipal bondholder or an Indian lessee immune from taxation.

The Commissioner of Internal Revenue would have this Honorable Court depart from its rulings repeatedly announced during the last century. The conservation and

orderly development of our institutions necessarily rest on our acceptance of the results of the past, and their use as lights to guide our steps in the future. These fundamental principles giving vitality as they did to the Constitution and forming the very foundation of our Federal Government should, it is most respectfully submitted, be affirmed. Legal precedents may sometimes be overruled, but the constitutional principles herein presented, hedged about as they are by precedents over a century old, should, it is respectfully submitted, not be disturbed.

The Decision of the Board of Tax Appeals as to Depreciation Deductions Was Correct.

There was also submitted to the Board of Tax Appeals the question whether or not the capitalized sums for drilling cost and development expense in connection with oil wells were returnable to Respondent through a depletion or a depreciation allowance. [R. 113-115.] The Board held that they were subject only to depreciation allowance. [R. 120-123.] As the court below held that all of Respondent's income from oil wells was immune from tax, it found it unnecessary to consider or treat this question. The precise question under the identical provision of the Revenue Act of 1926 and Regulations thereunder is now before this court in *United States v. Dakota-Montana Oil Company*, No. 434, October Term, 1932 and *Petroleum Exploration, Inc. v. Burnett*, No. 448, October Term, 1932, which will be argued before this case. Taxpayer's

contentions on this question are fully set forth in the brief of Messrs. Thomas R. Dempsey and A. Calder Mackay as *amici curiae* in those cases and taxpayer adopts the argument there presented as its argument on this phase of the instant case, without burdening the Court with a repetition thereof. For reasons there stated, we believe the decision of the Board of Tax Appeals on this question was correct.

CONCLUSION.

I.

The principles taxpayer is contending for have by virtue of the oft-repeated decisions of this Court become part of the Constitution. The decision of the Circuit Court is not an extension of the immunity doctrine. It, therefore, should be affirmed.

II.

If the judgment of the Court below is affirmed, then the depreciation question becomes academic. In any event, the Board's decision on this question is correct.

Respectfully submitted,

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(See Postscript pages 39 and 40.)

Postscript—Counsel for Taxpayer have this 2nd day of February, 1933, received a typewritten copy of the Government's brief which was received after Taxpayer's brief had been sent to the printer.

Taxpayer respectfully calls the Court's attention to some apparent misconception on the part of Government counsel with respect to facts in the record. Government counsel under Division A of his argument makes the statement that it is apparent that much of the property acquired was not presently required in connection with the city's water supply. This statement is not borne out by the evidence as the record shows that the water was obtained "from subterranean sources through which wells had been bored". [R. 98.]

Government counsel further states that the land leased to the Jergins Trust was "in effect segregated from the balance of the land and not devoted to water purposes". The record shows that 600 acres of land originally acquired have ever since been used by the city for water purposes. [R. 99.] Furthermore, the record shows that the 140 acres of land leased by the city to the Jergins Trust was part of the city's "water system property". [R. 100.] A reference to the lease further shows that there were reservoirs and water equipment on the land covered by the Jergins lease. [R. 101.]

The record clearly shows that the entire 600 acres of land, including that portion thereof leased to Jergins have at all times since their acquisition been used and now are being used by the city of Long Beach for the purpose of obtaining water to carry on the city's activities. The findings of fact made by the Board and the terms of the lease refute the Government's suggestion that that portion

of the land leased to Jergins Trust was abandoned by the city for water purposes.

The reference made by Government counsel to the "Auditor's Annual Report" is unwarranted as this is not a part of the record. Counsel for Taxpayer have not had an opportunity of examining this report. It does not appear from the Government's brief whether any of the funds derived by the city from the oil and gas were devoted to the purposes shown in the Auditor's Report. It is believed that the contentions of counsel in this respect have been answered by this Court in the case of *United States v. Baltimore and Ohio Railroad Company*, 17 Wall. 322; 21 L. ed. 597.

In the Government's brief attention is directed to the case of *Marin Water Company v. Town of Sausalito*, 168 Cal. 587. It is interesting to note in this case that the Court declared that the distinction between a proprietary and a governmental function was "wholly fictitious, and apt to produce embarrassing consequences if extended and applied to other cases than those then before that court". The cases wherein a distinction has been made between a governmental function and a proprietary function are tort cases and the distinction grew up because of the necessity of giving redress to a person injured by the city. However, it is extremely interesting to note that despite this fictitious distinction the California Court refused to allow an execution to issue against the water works and water system of a municipal corporation. It is respectfully submitted that this fictitious distinction cannot be used as a criterion for the determination of the limit of interference by the Federal Government with the functions and activities of the state government.

APPENDIX.

United States Constitution—Implied Provisions.

Constitution of the state of California:

"Article XIII, Sec. 1. Taxation to be in proportion to value. All property in the state except as otherwise in this Constitution provided, not exempt under the laws of the United States, shall be taxed in proportion to its value, to be ascertained as provided by law, or as hereinafter provided. * * *; and further provided, that property used for free public libraries and free museums, growing crops, property used exclusively for public schools, and such as may belong to the United States, this state, or to any county, city and county, or municipal corporation within this state shall be exempt from taxation, * * *."

Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 254:

"Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

Section 213 of the Revenue Act of 1924, c. 234, 43 Stat. 253, 267, 283 (U. S. C., Title 26, Secs. 954 and 985) contain provisions substantially the same as those of the corresponding section of the 1921 Act above quoted.

Due service of the within brief is hereby acknowledged this.....day of February, A. D. 1933.

_____

_____

Attorneys for Petitioner.

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IN THE

Supreme Court of the United States

No. 541.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

A. T. JERGINS TRUST, *Respondent.*

On Writ of Certiorari to the Circuit Court of Appeals for the Ninth Circuit.

BRIEF OF AMICUS CURIAE.
PUBLIC OWNERSHIP LEAGUE OF AMERICA.

CHARLES D. HAMEL,
JOHN ENRIETTO,
Counsel for Public Ownership League of America,
500 Shoreham Bldg.,
Washington, D. C.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

We hereby consent to the filing of the foregoing brief *amicus curiae* and acknowledge service of a copy thereof this.....day of February, A. D. 1933.

.....
Attorney for Petitioner.

.....
Attorney for Respondent.

AUTHORITIES.

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IN THE

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v.

A. T. JERGINS TRUST, *Respondent.*

On Writ of Certiorari to the Circuit Court of Appeals for the Ninth Circuit.

BRIEF OF PUBLIC OWNERSHIP LEAGUE OF AMERICA, AMICUS CURIAE.

The Public Ownership League of America represents an association of several thousand municipalities in the various states of the Union, which undertake to furnish a pure and adequate supply of water to their inhabitants through a waterworks system owned and operated by the municipality.

They are vitally interested in the definition and scope that this Honorable Court may give to a phrase so plastic

as "essential governmental function" in defining the outer extent of the Federal taxing power where that power infringes upon municipal activity.

However opinion may have been divided in forging their conclusions, *Gillespie v. Oklahoma*, 257 U. S. 501, and its counterpart, *Burnet v. Coronado Oil & Gas Company*, 285 U. S. 393, so far as *stare decisis* can establish a rule of conduct, establish that the income derived by a lessee from lands, acquired and used in the exercise of an essential governmental function by one sovereign cannot be burdened through taxation by the other sovereign.

Whatever may be felt as to the wisdom or the impregnability of that conclusion, the fact that opinion may be divided must not permit an easy escape by unduly limiting the field of "essential governmental functions." The suggestion that the rule of *Gillespie v. Oklahoma* will be strictly applied (Coronado Case, 285 U. S. 393) should carry the implication that the objects of the bounty will be limited and not that the Court will narrow its field of vision of "governmental functions." Efforts may be expected to escape the consequences of the decision by circumscribing the ambit. It is respectfully submitted that the ambit should be large and easy but those admitted to it may well be required to furnish indubitable proof of identification with the field. If the connection be deemed slight or the identification meagre, there may be reason for exclusion but not for narrowing the field.

It is in the light of these principles that this brief is submitted. Whether the function of gathering and distributing a pure and adequate supply of water for its inhabitants is an "essential governmental functions" is the sharp question before the Court.

The brief of the petitioner suggests that it is a "public" or "municipal" purpose but not a strictly governmental function. (P. 15). The basis for distinction between these labels is not indicated. Precedents avail little when politi-

cal philosophies differ. The switch from "essential governmental" to "strictly governmental" is another effort to draw in the lines of the field, regardless of who are admitted. If this means that supplying water is something in which the municipalities are interested but in which they need not engage, the municipalities respectfully differ with the United States attorneys.

Almost every municipality which is now engaged in supplying water is so engaged because of necessity and not convenience. The necessity may be born, as it was in this case, of the interference of private distribution with municipal functions of maintaining streets in sanitary condition; it may be born of anxiety concerning health, in which the system is found inadequate to avoid contamination but cannot be replaced by private capital; it may be born of impossibility of expanding the source of supply to meet the needs of the community because of a prohibitive rate base. The Spring Valley Water Company of San Francisco could not go to Hetch Hetchy, the Los Angeles Water Company could not go to the Owens River or the Colorado, and the East Bay Water Company could not go to the Mokelumne. In each case the municipality, of necessity, stepped in to make the necessary extension. Those are cases of necessity,—not of choice.

A survey indicates that in a total of all the incorporated municipalities within the United States, more than 95 per cent of them own and operate a water plant. It is therefore submitted that the owning and operating of water plants is quite a usual function of States and State Agencies.

The building of Hoover Dam by the Federal Government marks the entry of the United States into the problem of water supply and power. The pressure of population makes that a necessity which theretofore was but a dispensable luxury. A water supply problem in California makes the question there acute before the areas of abundant supply

have even vaguely felt its presence. The recognition of the necessity and governmental action based on it is the birth of an essential governmental function when to remain passive would invite social disaster.

What are the precedents? In a profound sense there are none. Ultimately the decision as to what is a governmental function will depend on individual opinion as to what is the appropriate function of government.

We begin with the dictum in *Flint v. Stone Tracy Co.*, 220 U. S. 107, 172 (1911). The quotations in the petitioner's brief (p. 16) are inadequate to show their basis. Water supply was not involved in any sense nor was artificial light. A railroad sought to escape the excise tax by insisting that its franchise made it a state agency. This, the court denied with this statement (p. 172):

> "If a State may not thus withdraw from the operation of a Federal taxing law a subject-matter of such taxation, it is difficult to see how the incorporation of companies whose service, though of a public nature, is nevertheless, *with a view to private profit*, can have the effect of denying the Federal right to reach such properties and activities for the purposes of revenue." (Italics ours)

The emphasis is on the element of profit. Ninety-five per cent of the publicly owned water systems of the country are not operated at or for a profit.

This case may be compared to decisions in which water supply was in question. In *Long Island Water Supply Co. v. Brooklyn*, 166 U. S., 685, this Court held that water supply is a public necessity and therefore may be secured by condemnation proceedings. See also *Farnham, On Water and Water Rights*, Sec. 155a.

In *New Orleans v. Morris*, 105 U. S. 600, this Court specifically held that waterworks could not have been seized on execution at any time since they were held by the city in its governmental capacity and therefore an obligation

of contract was not impaired by a state statute declaring that bonds received by the city for transfer of its waterworks could not be seized in payment of a debt.

Likewise the California courts have held that a waterworks system cannot be seized on execution. *Marin Water Co. v. Sausalito,* 49 Cal. App. 78.

Nor does the decision in *City of Trenton v. State of New Jersey,* 262 U. S. 182, indicate that water supply was a private function, for this Court denied that the city could set up the Fourteenth Amendment or the Impairment of Contract clause against a state law exacting a license fee for diverting water from a stream whereas the predecessor private owner had by legislative enactment the right to divert water from that stream. This Court (p. 191) felt the difficulty of stating any rule:

> "The basis of this distinction (between private and governmental functions) is difficult to state, and there is no established rule for the determination of what belongs to the one or the other class."

Whether, fundamentally, other principles may explain these decisions, it is evident that there is no fixed concept of governmental or proprietary functions or that any line of any sort can be defined so long as government serves the needs of man and so long as the pressure of population accentuates the demand for social control of the instruments to satisfy those needs.

The tort cases relied upon extensively by the government are will-o'-the-wisps. The tort law is in a chaotic state, representing great diversity of local opinion on the problem of distributing the individual injury over the local community.

The law is in flux and change and presents attempts to reconcile doctrines based on the immunity of the sovereign from suit with the social demand that the burden of injury be shifted to the group responsible for it. It was very

easy in cases not historically, in this country, connected with municipal endeavor but associated with concepts of profit to find occasion for shifting the burden.

An electricity case shows the absurdity of the tort distinctions. A was killed by an alternating current. The city supplied direct current for street lighting; alternating current to consumers. The State Court held the city liable for the death of A and intimated strongly it would not have been held if A had been killed by the direct current. *Hodgins v. Bay City,* 156 Mich. 687.

That the supply of water is not always regarded as a proprietary enterprise is shown by those cases which deny liability where the failure of water through lack of due care, resulted in fire loss. The courts find the duty to the public and not to the individual though he may have paid rates to get this very supply. *Wright v. Augusta,* 78 Ga. 241; *Edgerly v. Concord,* 59 N. H. 78; *Springfield Fire & Marine Insurance Co. v. Keeseville,* 148 N. Y. 46, 57; 42 N. E. 405. In the latter case the court asserted that the establishment and operation of waterworks was a governmental function. If this were as the petitioner contends but a proprietary enterprise, the municipality should be fully liable to a consumer who has paid for the service.

Likewise for furnishing contaminated or impure water it would seem the city can be held liable only on evidence of *gross* negligence in permitting the contamination to occur.

> *Stubbs v. Rochester,* 226 N. Y. 516; 124 N. E. 137.
> *Keever v. City of Mankato,* 113 Minn. 55; 129 N. W. 158.

Nor is there an implied warranty of purity. *Canavan v. City of Mechanicsville,* 229 N. Y. 473; 128 N. E. 882. Yet if water supply were a proprietary operation, it is strange that lack of ordinary care in rendering service does not result in liability and there is no reason why the city

should not be held to the same liability as a private dispenser of liquids.

When waterworks or appurtenances are used for dual purposes of fire protection and other purposes such as flushing streets, valiant efforts are made to distinguish the particular function or use in connection with which the injury occurred and to determine the liability accordingly.

See *Winona v. Botzet*, 169 Fed. 321, injuries caused by a horse frightened by the whistle of a waterworks, and *Judson v. Winsted*, 80 Conn. 364; 68 Atl. 999, injuries caused by a horse frightened by the flushing of a hydrant.

Fire-fighting is a recognized governmental activity, *Brinkmeyer v. City of Evansville*, 29 Ind. 187, (1867); *Wheeler v. City of Cincinnati*, 19 Oh. St. 19 (1869); the preservation of public health is likewise a governmental concern. *Ambrosini v. U. S.*, 187 U. S. 1 (1902); *Harris v. District of Columbia*, 256 U. S. 650 (1921); cleaning streets is a matter of governmental concern. *Harris v. District of Columbia*, (*supra*); *Mayor of Savannah v. Jordan*, 142 Ga. 409; 83 S. E. 109 (1914); contra, *Musano v. Mayor of New York*, 160 N. Y. 123; 54 N. E. 744 (1899); sewers are a governmental concern, *Smiths' Admr. v. City of Louisville*, 146 Ky. 562; 43 S. W. 3 (1912); contra, *Murphy v. City of Indianapolis*, 158 Ind. 238; 63 N. E. 469 (1902)—yet these functions are closely related, at times, inseparable from the function of supplying water. There are no bright lines in municipal administration and tort concepts furnish no clue to solution of questions of taxation. If the tort precedents are followed, they will lead to a hopeless morass, the solution of which will come only through legislative imposition of liability.

Water is furnished generally for compensation, not necessarily for profit, and gives rise to a fertile field for holding a municipality liable in tort. The element of compensation, though not directly apparent, affords the common operative fact to induce a judge to take these services out of the sphere of governmental enterprises.

If the courts fully appreciated and gave practical effect to the fact that taxpayers pay for all municipal enterprises and that they must all be legally justified as accruing for their benefit, we might find a greater disposition to drop the uncertain and largely outworn distinction between governmental and corporate enterprises which have plagued the courts in a futile effort at uniform classification and have challenged the logic of the law and justice of its administration.

Where two governmental agencies occupy the same field, in which one demands freedom of action and the other demands revenue, is not any attempt to delimit the field of governmental or proprietary activity an illusion? The power of the Federal Government is dependent on its power to command the individual. Are we not shifting money from one pocket to another pocket when a municipal enterprise is burdened? The question of fact whether it is so burdened may occasion split of opinion, but assuming the burden is present, it is duplication to take from a municipality by taxation what that municipality must exact in turn from the people. It is a transfer of the burden of the Federal Government to the municipalities of the land. It is not answered by pointing out that the municipalities need not have undertaken the particular function. History shows that this arose from necessity not from choice. The pressure of social necessity should be recognized in making constitutional distinctions. Otherwise this would lead to but one consequence—Federal dictation of local activity.

Respectfully submitted,

CHARLES D. HAMEL,
JOHN ENRIETTO,
Counsel for Petitioner.

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IN THE

SUPREME COURT

OF THE

UNITED STATES.

October Term, 1932

No. 541.

David Burnet, Commissioner of Internal Revenue,

Petitioner,

vs.

A. T. Jergins Trust,

Respondent.

PETITION FOR REHEARING.

MOTION TO STAY MANDATE.

THOMAS R. DEMPSEY,
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Parker, Stone & Baird Co., Law Printers, Los Angeles.

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Respondent.

PETITION FOR REHEARING.

Comes now A. T. Jergins Trust by its attorneys, A. Calder Mackay and Marc F. Mitchell, and presents this its petition for a rehearing of the above entitled cause (judgment having been entered on March 13, 1933) under Rule 33 of the Revised Rules of the Supreme Court of the United States, and in support thereof respectfully urges:

THAT THE OPINION OF THIS HONORABLE COURT UNJUSTLY DISCRIMINATES AGAINST THE SOVEREIGNTY OF THE STATE OF CALIFORNIA AND IS A DEPARTURE FROM THE FUNDAMENTAL LAW OF THE LAND.

"That by clear implication the means employed by the general government to carry into operation the powers

granted to it are exempt from taxation by the states, as are those employed by the states exempt from taxation by the general government." This we understand to be the principle upon which the case stands or falls. As the Court has said it is "settled by a wealth of authority". We are unable to see, however, that the "considerations which have led to the condemnation of taxes in other circumstances are here absent". We understand from what the Court has said that instrumentalities or "means employed" by the states "to carry into operation the powers granted to it are exempt from taxation". We also understand that the State of California through its agency, the City of Long Beach, has the power to own land and having such power, has the further power to select its methods, means and instrumentalities of developing its lands and that this is what it did in the present case. We understand from the facts of the case that the "means employed" by it "to carry into operation the powers" which it thus had was a lease to the Jergins Trust. True "the levy is not upon the property of the municipality, nor upon the income it derives from its property, is not upon the city's share of the oil recovered, the lease, or the gross income therefrom". It is just as true that in the cases of *Gillespie v. State of Oklahoma,* 257 U. S. 501, and *Burnet v. Coronado Oil & Gas. Co.,* 285 U. S. 393, 76 L. Ed. 815, the levy was not upon the property of the government or the state nor upon the income they derived from their property, was not upon the government's or state's share of the oil recovered, the leases, or the gross income therefrom. Thus far, therefore, the three cases are identical and the principle fits all three. In this case the Court goes

further and finds "The law measures the assessment by the net income of the respondent". So did the law in the Gillespie case and so did the law in the Coronado case measure the assessment by the net income of the Gillespie and Coronado companies, respectively, and so were their operations "carried on in a private and not a public capacity for the personal gain" of the two companies. So far we are still precisely on the same footing as those cases. The only distinction pointed out by the Court between this case and the Gillespie and Coronado cases is that "In both of those cases the sovereign was acting as a trustee of an express trust with regard to the land leased". The Court did not define the character of the trust in which the City of Long Beach was acting as trustee, but the inference is that it is implied rather than expressed, or that it is general rather than specific. In other words, the trusts in the Gillespie and Coronado cases both devoted the income to a direct and specific purpose; in the Gillespie case, to the Indians as provided by treaty and in the Coronado case, to state schools as provided by law. In the case at bar the income is devoted by law to general governmental purposes. It is, we believe, the only distinction which can be made between the Gillespie and Coronado cases and this case. The distinction then seems to be that if the state's share of income from an oil lease is devoted to one governmental purpose, a tax upon the leased share in the hands of the lessee is "more definite and direct" and therefore void, but if the state's or city's share of the income from the oil lease is devoted to several governmental purposes according to law it is not so "definite and direct", and is "so remote from any governmental function as to render

the effect of the exaction inconsiderable as respects the activities of the city". We had generally supposed, and urge this thought upon the Court for reconsideration, that if more than one governmental activity were likely to be burdened by the imposition of a tax this fact would make the tax more objectionable than if it burdened only one governmental activity. But the principle here contended for, we submit, has never heretofore been confined to express trusts.

The City of Long Beach, having received delegated authority to own and use land, had an *express public* function to perform. Human language could not more clearly confer an "express trust" than the written delegation of power conferred by the state upon the City of Long Beach.

As we understand this Honorable Court's opinion in the case of *Gillespie v. State of Oklahoma,* 257 U. S. 501, the exemption from taxation was determined on "general principles". Furthermore, the question of the remoteness of the tax was specifically answered in the Court's opinion in which it is stated at page 505:

> "* * * That such leases were not taxable, went on *general principles,* * * *. The criterion of interference by the states with interstate commerce is one of degree. * * * The rule as to instrumentalities of the United States, on the other hand, is *absolute in form and at least stricter in substance.* * * * 'A tax upon the leases is a tax upon the power to make them, and could be used to destroy the power to make them.' * * * The step from this to the invalidity of the tax upon income from the leases is not long. * * *." (Italics ours.)

At page 506:

> "* * * The same considerations that invalidate a tax upon the leases invalidate a tax upon the profits of the leases; * * *."

The only interference with a governmental agency which exists in a number of cases where the tax has been held void is that the burden of the tax indirectly comes from the government by reason of the fact that its (the government's) activities cost more if the tax is levied and paid by the governmental agency operating in a private capacity. It seems to be the only interference which takes place when a state attempts to tax the interest on United States Government bonds in the hands of private parties, or when the United States attempts to tax the interest upon state bonds in the hands of private parties. Here, however, as in the Gillespie and Coronado cases, the admission of the power to levy the tax admits the power to perform a series of other acts which would be so serious in their nature as to directly interfere with the control and management of the city's property and prevent it from exercising its independent judgment in the development of its property held by it in trust for the public use and in the management of its fiscal affairs. We refer to the power of sale which is a necessary incident to the power to tax. If the government may tax the income of the Jergins Trust it may sell its leasehold estate in the city land for the tax. It may then by the incidental power pass the estate to any other agency which might purchase it and compel the city to accept as its agency an agency wholly unsatisfactory to it and force it to deal with agencies involuntarily and

regardless of its wishes in the matter. This character of interference, we submit, is more serious and more to be avoided than the merely pecuniary one of causing, by a tax, the city or state to pay a higher royalty or interest rate.

We sincerely urge that the decision of this Honorable Court is discriminatory and works a grave injustice upon the city as well as upon the sovereign State of California. Long Beach, in the utilization of its lands held for public purposes, should be as free from tax as the State of Oklahoma is in the utilization of its lands. An implied governmental function should be clothed with as much sanctity as an express governmental function. The ownership and use by the City of Long Beach of its lands were permitted by written delegated authority which amounts to an "express trust".

In view of the foregoing and in view of the great importance of this question, it is respectfully prayed that this petition for rehearing be granted and that Taxpayer be given an opportunity for further argument.

Respectfully submitted,

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Los Angeles, California,

MARC F. MITCHELL,
GEORGE C. WITTER,
1002 Petroleum Securities Building,
Los Angeles, California,
Attorneys for A. T. Jergins Trust.

Certificate of Counsel.

I, A. Calder Mackay, counsel for the above named A. T. Jergins Trust, do hereby certify that the foregoing petition for a rehearing of this cause is presented in good faith and not for delay.

A. CALDER MACKAY,
Counsel for A. T. Jergins Trust.

IN THE

SUPREME COURT

OF THE

UNITED STATES.

October Term, 1932

No. 541.

David Burnet, Commissioner of Internal Revenue,

Petitioner,

vs.

A. T. Jergins Trust,

Respondent.

MOTION TO STAY ISSUANCE OF MANDATE.

Now comes A. T. Jergins Trust, the Respondent in the above-entitled cause, by its attorneys, and shows to this Court:

Within the time allowed by the rules of this Court said Respondent is filing its petition for a rehearing of this cause and a modification of the judgment of this Court entered herein on March 13, 1933, for the reasons set forth in said petition.

Under Rule 34 of this Court such petition will not operate to stay the mandate of this Court, and such mandate will issue as of course after the expiration of twenty-five days from the day said judgment was entered, unless otherwise ordered.

In view of the nature of said petition for rehearing and the end sought to be accomplished thereby, no useful purpose would be subserved by the issuance of the mandate of this Court prior to the disposition of said petition; but, on the contrary, unnecessary complications and trouble would result.

Wherefore, said Respondent prays that the mandate of this Court be stayed and withheld until said petition for a rehearing shall have been acted upon and disposed of by this Court.

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MARC F. MITCHELL,

GEORGE C. WITTER,

1002 Petroleum Securities Building,
Los Angeles, California,

Attorneys for A. T. Jergins Trust.

Due service of the within petition and motion is hereby acknowledged this.....day of April, A. D. 1933.

Attorneys for David Burnet, Commissioner.

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CHARLES ELMORE CROPLEY
CLERK

IN THE

SUPREME COURT

OF THE

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October Term, 1932
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David Burnet, Commissioner of Internal Revenue,
Petitioner,
vs.
A. T. Jergins Trust,
Respondent.

Brief of Nowland M. Reid, City Attorney of the City of Long Beach, California, and Geo. W. Trammell, Jr., Assistant City Attorney, as Amici Curiae.

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IN THE

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David Burnet, Commissioner of Internal Revenue,
Petitioner,

vs.

A. T. Jergins Trust,
Respondent.

Brief of Nowland M. Reid, City Attorney of the City of Long Beach, California, and Geo. W. Trammell, Jr., Assistant City Attorney, as Amici Curiae.

I.

The Opinion of This Honorable Court Unjustly Discriminates Against the Sovereignty of the State of California and Is a Departure From the Fundamental Law of the Land.

In its opinion, this Honorable Court attempts to distinguish the instant case from its opinions in the cases of *Gillespie v. State of Oklahoma,* 257 U. S. 501, and *Burnet v. Coronado Oil & Gas Company,* 285 U. S. 393, 76 L. Ed. 815, on the ground that in the latter two cases "the sovereign was acting as a trustee of an express trust with regard to the lands leased". The principles of immunity herein contended for have never been confined to the per-

formance of a special or express governmental trust. The foundation for the immunity doctrine is the opinion of Chief Justice Marshall in the case of *McCulloch v. The State of Maryland,* 4 Wheat. 316. The bank in that case was held to be an instrumentality of the Federal Government and as such was immune from taxation. There was no provision in the Constitution which gave the Federal Government the "express" right to own or operate a bank, or to use a bank as a federal depositary; such a right, Chief Justice Marshall stated, was implied from the very nature of the Government. It is a universal doctrine in the construction of all instruments that what is implied is as much a part of the instrument as what is expressed. Had the immunity doctrine at that time been limited to the fulfillment of "express trusts" of a governmental nature, the famous decision would have been reversed.

Chief Justice Marshall recognized that all the powers of a government could not be specifically enumerated in a constitution. His decision in the foregoing case rests upon the fundamental principle that our dual system of government could not exist unless the instrumentalities of the State and Federal sovereigns should be free from interference by one another. He stated, at page 421:

> "* * * Let the end be legitimate, let it be within the scope of the constitution, and all means which are appropriate, which are plainly adapted to that end, which are not prohibited, but consist with the letter and spirit of the constitution, are constitutional."

The attorneys representing the State of Maryland most vigorously argued that the principle of immunity should not be extended to a federal instrumentality and especially

if that instrumentality was not one created under express provisions of the Constitution. In speaking of the immunity doctrine, Chief Justice Marshall stated, at page 430:

> "* * * We have a principle which is safe for the states, and safe for the Union. We are relieved, as we ought to be, from clashing sovereignty; from interfering powers; from a repugnancy between a right in one government to pull down what there is, an acknowledged right in another to build up; from the incompatibility of a right in one government to destroy what there is a right in another to preserve. We are not driven to the perplexing inquiry, so unfit for the judicial department what degree of taxation is the legitimate use, and what degree may amount to the abuse of the power. The attempt to use it on the means employed by the government of the Union, in pursuance of the Constitution, is itself an abuse, because it is the usurpation of a power which the people of a single state cannot give."

The foregoing principles during the last one hundred years have been iterated and reiterated and the members of the Bar have considered those principles as much a part of the Constitution as the express provisions therein. The denial of the application of those principles to the case at bar, it seems, is a direct departure from these very fundamental principles. At the time the treaties were made with the Indians who were sent to Oklahoma, their lands were not thought to be underlain with oil. It, therefore, may be safely stated that there was no "express trust" imposed upon the Federal Government to lease the lands for oil. The Federal Government merely had a treaty obligation to fulfill and in this sense it was a trustee.

However, this Honorable Court in the *Gillespie* case did not base its opinion upon an "express trust". In this case this Honorable Court stated, at page 505:

> "* * * That such leases were not taxable, went on *general principles,* * * *. The criterion of interference by the states with interstate commerce is one of degree. * * * The rule as to instrumentalities of the United States, on the other hand, is *absolute in form and at least stricter in substance.* * * * 'A tax upon the leases is a tax upon the power to make them, and could be used to destroy the power to make them.' * * * The step from this to the invalidity of the tax upon income from the leases is not long. * * *" (Italics ours.)

And, at page 506, the Honorable Court stated:

> "* * * The same considerations that invalidate a tax upon the leases invalidate a tax upon the profits of the leases; * * *."

The "general principles" referred to in the foregoing case where the principles laid down by Justice Marshall, and their application was most certainly not confined to an "express governmental trust". A failure to apply these principles to the case at bar is a discrimination against the state of California and a departure from the fundamental law of the land.

The school lands at the time acquired by the state of Oklahoma were thought not to contain mineral; indeed, there was a conscious effort on the part of the Federal Government to retain all mineral lands. Consequently, there was no "express" provision imposing a duty upon the state of Oklahoma to lease its lands for oil. The state of Oklahoma, like the City of Long Beach, had merely

the duty of utilizing its lands. The immunity allowed by this Honorable Court in the case of *Burnet v. Coronado Oil & Gas Company,* 285 U. S. 393, 76 L. Ed. 815, so far as that opinion is concerned, was not based upon a specific trust other than a general governmental duty. In that case this Honorable Court again reviewed the many decisions theretofore announced by it and approved its long established principles of exempting from taxation by the states of the instrumentalities of the United States, and the means and operations whereby it exerted governmental powers.

The immunity doctrine applied to holders of public securities is not based upon a trust any more specifically expressed than the trust imposed by the state of California upon the City of Long Beach. It is true that under the Federal Constitution, the Federal Government is given the power to raise revenues and to borrow money. However, there is no express provision permitting or authorizing the Federal Government to issue bonds; that means of raising money is necessarily implied. This Honorable Court, in the case of *The Macallen Company v. Commonwealth,* 279 U. S. 620, in referring to these principles, states, at page 631:

> "A liberal application of the foregoing principles, which find confirmation especially in the later decisions of this court, *is essential to the preservation of the constitutional limitations* imposed upon the taxing power of the states. Let it once be conceded that such limitations may be evaded by the adoption of a delusive name to characterize the tax or form of words to describe it, and the destruction of the vitality of these necessary safeguards will soon follow." (Italics ours.)

The necessity for the perpetuation of the foregoing principles is certainly impregnated in the hearts and souls of all of the members of the Bar. These principles, by virtue of the oft-repeated decisions of this court, have become part of the Constitution itself. If these principles are vital to the Constitution, then it is believed that they should be liberally applied, in order that their *vitality* may be maintained. These principles, by limiting their application, may be as effectively killed as a complete repudiation thereof. If these principles are to be applied only in the cases of "express trusts", then the reasons for the principles cease to exist. This naturally follows because of the impossibility of creating "express trusts" for the performance of every public duty.

The City of Long Beach was not built for the sole object of being incorporated, but was incorporated as affording the best means of being well governed. It obtained all of its powers from specific constitutional and statutory provisions of the sovereign state of California. Among the powers granted by the state to the city was the power to acquire, own and use land for the "common good". [R. 98.] The trust imposed upon the City of Long Beach was expressed in writing and, therefore, it is most sincerely urged, constitutes more of an "express trust" than can be found in either the case of *Burnet v. Coronado Oil & Gas Company*, 285 U. S. 393, 76 L. Ed. 815, or *Gillespie v. State of Oklahoma*, 257 U. S. 501. The pronouncement by Chief Justice Marshall of immunity principles was not confined to a single purpose. If we may rely upon the importance that has been attached to the preservation of these principles, no one would be able to forecast the baneful effect that a narrow construction

may have upon the operations of the State and Federal Governments.

The City of Long Beach, having received delegated authority to own and use land, had an *express public* function to perform. Human language could not more clearly confer an "express trust" than the written delegation of power conferred by the state upon the City of Long Beach. Certainly Long Beach is as much entitled to the complete use of its property as is the state of Oklahoma. Oklahoma merely utilized lands which it had acquired by grant from the Federal Government. Long Beach was only utilizing lands which it had acquired under specific authority (express trust) from the state of California. The lands of the City of Long Beach could be used only for governmental purposes—for the common good. A doctrine inferring that governmental lands may be used by the government for other than governmental purposes is a strange and dangerous doctrine in our democracy. Governmental lands have always been considered to be held in sacred trust—their use is as much a part of that sacred trust as their ownership.

To deny the City of Long Beach the same considerations that were extended to the state of Oklahoma is discriminatory and works a grave injustice upon the city, as well as upon the sovereign state of California. In principle, it is respectfully submitted, there is no difference between the case at bar and the Coronado and Gillespie cases. If anything, the utilization of the lands of the City of Long Beach through its instrumentality (which was created for a specific purpose) is closer to the exercise of governmental functions than is the utilization of school lands by the state of Oklahoma.

It is respectfully urged that these fundamental constitutional principles, if they are to be perpetuated, should have uniform application, and that the City of Long Beach should not be discriminated against in the exertion of its governmental powers. Long Beach is just as much entitled to exert its constitutional and charter powers without interference by the Federal Tax Bureau as the state of Oklahoma. The conservation and orderly development of our institutions necessarily rest upon our acceptance of the results of the past and their use as lights to guide our steps in the future. If confusion and turmoil are to be avoided, then settled constitutional principles should not be directly or indirectly overthrown. The security of this great nation by the perpetuation of the Constitution can only be secured by the stability of teachings and the sanctity which surrounds the foregoing principles. To disturb the permanency of these principles would be to weaken the security of the Federal Government. If the application of these principles is to be so restricted as to permit the interference (so valiantly fought by Chief Justice Marshall) by the Federal taxing authorities of the means and instrumentalities of the state governments created and used for the fulfillment of public trusts, then the reserved rights of states and their instrumentalities, as provided for in the Tenth Amendment to the Constitution, are of little worth. Legal precedents may sometimes be overruled, but the constitutional principles herein referred to, hedged about as they are by precedents over a century old, should not be devitalized by restrictions against their reasonable application.

In view of the great importance of the questions herein presented and in view of the discriminatory effect of the

decision against the sovereign state of California, it is respectfully prayed that this petition for rehearing be granted and that an opportunity be given for further argument.

Respectfully submitted,

GLEN E. HUNTSBERGER.

NOWLAND M. REID,
City Attorney of the City of Long Beach, California,

GEO. W. TRAMMELL, JR.,
Assistant City Attorney,

Of Counsel.

Due service of the within brief is hereby acknowledged this_____day of April, A. D. 1933.

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Attorneys for David Burnet, Commissioner.

SUPREME COURT OF THE UNITED STATES.

No. 541.—October Term, 1932.

David Burnet, Commissioner of Internal Revenue, Petitioner, *vs.* A. T. Jergins Trust.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[March 13, 1933.]

Mr. Justice Roberts delivered the opinion of the Court.

Prior to 1911 the city of Long Beach, California, procured water from companies owning and operating artesian wells on lands lying outside the city. The service proving inadequate and unsatisfactory the municipality in 1911 acquired these lands, comprising about 600 acres, and the appurtenant systems, and has since used the tract for water supply and other purposes. In 1922 oil was discovered in the vicinity, and the respondent was organized under the law of California with the intention of obtaining an oil and gas lease on the lands in question. The city leased to the respondent 140 acres, the agreement stipulating that the lessee should receive sixty per cent. of the proceeds of oil and gas recovered and the city forty per cent. As permitted by the lease the oil and gas produced have been sold under a contract made by the city and the respondent as joint vendors. The trust has derived substantial income from the lease.

Upon audit of the taxpayer's returns for the years 1922, 1923 and 1924, the Commissioner, by formal written notification, proposed a deficiency in income taxes for those years. The respondent appealed to the United States Board of Tax Appeals raising two issues, (1) Whether its income derived from the lease was immune from taxation, and, if not, (2) Whether capitalized expenses for drilling and developing its oil wells were to be returned through depletion allowance, as ruled by the Commissioner, or by way of depreciation. The Board held the income taxable and the intangible development costs recoverable through depreciation charges. The Circuit Court of Appeals upon cross-petitions for review de-

cided that the income from the lease was immune from federal income tax, and therefore found it unnecessary to pass upon the matter of depreciation allowance presented by the Commissioner's petition. Both questions are raised by the petition for certiorari.

The respondent, in support of its claim of immunity, relies upon the principle that a tax upon instrumentalities of the states is forbidden by the federal constitution; that by clear implication the means employed by the general government to carry into operation the powers granted to it are exempt from taxation by the states, as are those employed by the states exempt from taxation by the general government. The principle is settled by a wealth of authority and has been applied in varying circumstances; has been recently fully discussed and the authorities collected and commented upon in decisions of this court (*Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514; *Willcuts* v. *Bunn*, 282 U. S. 216; *Indian Territory Illuminating Oil Co.* v. *Board of Equalization*, and *Indian Territory Illuminating Oil Co.* v. *Board of County Commissioners*, Nos. 356, 357, October Term 1932, decided February 13, 1933); and no purpose would be served by a repetition of what was there said.

The Revenue Acts do not discriminate between the respondent and others similarly situated, in the imposition of the income tax. If the respondent is exempt from the exaction the conclusion must follow because the tax directly burdens the functions of the state acting through the city of Long Beach. Considerations which have led to the condemnation of taxes in other circumstances are here absent. The levy is not upon the property of the municipality, nor upon the income it derives from its property, is not upon the city's share of the oil recovered, the lease, or the gross income therefrom. The law measures the assessment by the net income of the respondent, whose operations are carried on in a private and not in a public capacity for the personal gain of its *cestuis que trust*. The government asserts that the incidence of the tax is so remote from the activities of the municipality as to have no substantial adverse effect upon them. The respondent insists that as lessee of the lands in question it is a governmental agency and any tax laid upon its income directly burdens governmental functions.

In *Metcalf & Eddy* v. *Mitchell*, *supra*, this court said:

"Just what instrumentalities of either a state or the federal government are exempt from taxation by the other cannot be stated in terms of universal application".

And further:

"As cases arise, lying between the two extremes, it becomes necessary to draw the line which separates those activities having some relation to government, which are nevertheless subject to taxation, from those which are immune. Experience has shown that there is no formula by which that line may be plotted with precision in advance. But recourse may be had to the reason upon which the rule rests, and which must be the guiding principle to control its operation. Its origin was due to the essential requirement of our constitutional system that the federal government must exercise its authority within the territorial limits of the states; and it rests on the conviction that each government, in order that it may administer its affairs within its own sphere, must be left free from undue interference by the other . . . ."

It was there pointed out that while in one aspect the extent of the exemption must finally depend upon the effect of the tax upon the functions of the government alleged to be affected, still the nature of the governmental agencies and the mode of their constitution may not be disregarded in passing upon the question of tax exemption. An agency may be so intimately connected with the exercise of a power or the performance of a duty by the government that any taxation of it would be a direct interference with the functions of government itself. In *Baltimore Shipbuilding Co.* v. *Baltimore,* 195 U. S. 375, it was said:

". . . it seems to us extravagant to say that an independent private corporation for gain, created by a State, is exempt from state taxation, either in its corporate person, or its property, because it is employed by the United States, even if the work for which it is employed is important and takes much of its time."

The statement holds true as well, when the positions of the sovereigns are reversed.

The application of the doctrine of implied immunity must be practical (*Railroad Company* v. *Peniston,* 18 Wall. 5, 31, 36) and should have regard to the circumstances disclosed. We think that in the present instance the subject of the tax is so remote from any governmental function as to render the effect of the exaction inconsiderable as respects the activities of the city. Compare *Alward* v. *Johnson,* 282 U. S. 509, 514. Its collection is not inconsistent with and does not trench upon the immunity of the state as a sovereign. The income of the respondent from the lease is not immune from federal income tax.

The respondent relies upon *Gillespie* v. *Oklahoma,* 257 U. S. 501, and *Burnet* v. *Coronado Oil & Gas Co.,* 285 U. S. 393, as authorities binding upon us and requiring a decision in its favor. In both of those cases the sovereign was acting as the trustee of an express trust with regard to the lands leased. In both the burden upon the public use was more definite and direct than in the present case. As said in the *Coronado* case, the doctrine of *Gillespie* v. *Oklahoma* is to be applied strictly and only in circumstances closely analogous to those which it disclosed. The decisions relied on cannot be held to be authority upon the facts presented by this record.

The petitioner also asserts that the Board of Tax Appeals was in error in holding that the cost of drilling should be amortized by way of depreciation charges, and not through the statutory allowance for depletion. The identical issue is involved and settled in favor of petitioner by *United States* v. *Dakota-Montana Oil Co.,* No. 434, October Term, 1932, and *Petroleum Exploration* v. *Burnet,* No. 448, October Term, 1932, decided this day.

The judgment is reversed and the cause remanded for further proceedings in conformity with this opinion.

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.

END OF CASE